[JOINT COMMITTEE PRINT]

TAX REFORM PROPOSALS: CORPORATE TAXATION

For the Use

OF THE

COMMITTEE ON WAYS AND MEANS

AND THE

COMMITTEE ON FINANCE

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

SEPTEMBER 19, 1985

U.S. GOVERNMENT PRINTING OFFICE

52-238 O WASHINGTON : 1985 JCS-40-85

J 862-48
S 362-32
H 782-41

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INTRODUCTION

This pamphlet[1] is prepared by the staff of the Joint Committee on Taxation for the House Committee on Ways and Means and Senate Committee on Finance in connection with the respective committee review of comprehensive tax reform proposals. This pamphlet is one of a series of tax reform proposal pamphlets. It describes and analyzes tax provisions and proposals relating to corporate taxation.

The pamphlet describes present law tax provisions and the tax reform proposal made by President Reagan ("The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity," May 1985, referred to as the "Administration Proposal"), the 1984 Treasury Department report to the President ("Tax Reform for Fairness, Simplicity, and Economic Growth," November 1984, referred to as the "Treasury Report"), Congressional proposals (identified by the primary sponsors), and other related proposals. Each part of the pamphlet includes an analysis of the tax-related issues.

The first part of the pamphlet is a discussion of corporate tax rates. Part two discusses the two-tier tax on distributed income and certain exceptions. Part three discusses distributions and liquidating sales of appreciated assets and the *General Utilities* doctrine. Part four discusses entity classification, and part five discusses certain other corporate issues.

Additional corporate tax proposals relating to mergers and acquisitions are discussed in two Joint Committee on Taxation staff pamphlets *Federal Income Tax Aspects of Mergers and Acquisitions* (JCS 6–85), March 29, 1985; and *Federal Income Tax Aspects of Hostile Takeovers and Other Corporate Mergers and Acquisitions (and S. 420, S. 476 and S. 632)* (JCS 9–85), April 19, 1985. Proposals relating to corporate net operating loss carryovers are discussed in a Joint Committee on Taxation staff pamphlet, *Special Limitations on the Use of Net Operating Loss Carryovers and Other Tax Attributes of Corporations* (JCS 16–85), May 21, 1985.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Tax Reform Proposals: Corporate Taxation* (JCS–40–85), September 19, 1985.

I. CORPORATE TAX RATES

Present Law and Background

Corporate taxable income is subject to tax under a five-step graduated tax rate structure. The top corporate tax rate is 46 percent on taxable income over $100,000.

The corporate taxable income brackets and tax rates are presented in the following table:

Taxable income	*Tax rate*
Not over $25,000	15
Over $25,000 but not over $50,000	18
Over $50,000 but not over $75,000	30
Over $75,000 but not over $100,000	40
Over $100,000	46

This schedule of corporate tax rates, which reduced the previously applicable rates for up to $50,000 of taxable income, was enacted in the Economic Recovery Tax Act of 1981 (ERTA), effective for 1983 and later years. For 1982, the applicable rates were 16 percent for taxable income not over $25,000, and 19 percent for taxable income over $25,000 but not over $50,000. For taxable years after 1979 and before 1982, the rates were 17 percent and 20 percent, respectively.

An additional 5-percent corporate tax is imposed on a corporation's taxable income in excess of $1 million. However, the maximum additional tax is $20,250. Thus, the benefit of the graduated rates is eliminated for corporations with income in excess of $1,405,000. This provision was enacted in the Deficit Reduction Act of 1984, effective for taxable years beginning after 1983.

Rules are provided to prevent the proliferation of the benefits of the graduated rates through the use of commonly controlled multiple corporations (secs. 1551, 1561-1564).

Other statutory provisions attempt to limit the use of corporations to avoid the individual tax rates. These are principally the accumulated earnings tax (secs. 531 *et. seq.*), the personal holding company tax (secs. 541 *et. seq.*), and certain personal service corporation provisions (sec. 269A).

An alternative tax rate of 28 percent applies to a corporation's net capital gain (the excess of net long-term capital gain over net short-term capital loss) if the tax computed using that rate is lower than the corporation's regular tax (sec. 1201).

Administration Proposal

Under the Administration proposal, tax would be imposed on corporations under the following schedule:

Taxable income	*Tax rate*
Not over $25,000	15
Over $25,000 but not over $50,000	18
Over $50,000 but not over $75,000	25
Over $75,000	33

The graduated rates would be phased out for corporations with taxable income over $140,000. Corporations with taxable income of $360,000 or more would pay, in effect, a flat tax at the 33 percent rate.

The alternative tax for net capital gains of corporations would remain at 28 percent.

The proposed tax rates would be effective July 1, 1986. Thus, the rate schedule for taxable years including July 1, 1986 would reflect blended rates based on the new rates effective on such date (*see* sec. 15).

Other Proposals

1984 Treasury Report

The 1984 Treasury Report would replace the present graduated corporate rate schedule with a single 33 percent rate on corporate income. The Treasury Report would repeal the current provisions concerning multiple related corporations and domestic personal holding companies.

S. 409 and H.R. 800 (Bradley-Gephardt)

The Bradley-Gephardt bill would replace the present law rate schedule with a single 30 percent rate on corporate income (the same as the top individual rate). This bill would repeal the current provisions concerning multiple related corporations, personal holding companies, personal service corporations, and the accumulated earnings tax. The bill would repeal the preferential rates for net capital gain.

H.R. 2222 and S. 1006 (Kemp-Kasten)

Under the Kemp-Kasten bill, income of large corporations generally would be taxed at a 35 percent rate. However, for corporate income under $100,000, graduated rates would apply. The first $50,000 of corporate income would be taxed at a 15 percent rate, and the second $50,000 would be taxed at a 25 percent rate. This rate reduction would save corporations with $100,000 of taxable income a total of $15,000 of tax (i.e., the difference between $35,000, the tax liability at a 35 percent rate, and $20,000, the tax liability at the proposed graduated rates). The benefit of graduated rates would not be phased out as under present law. For corporations electing capital gains treatment (rather than ordinary income treatment with basis indexed for inflation) the corporate capital gains rate would be 20 percent.

Analysis

The Administration proposal would retain a graduated rate structure for lower income corporations. The proposal states that adoption of a flat corporate rate (as proposed in the 1984 Treasury Report) would result in a substantial tax increase for low income corporations even though large corporations would benefit from a rate cut.[1a] The proposal seeks to retain some rate cut benefit for smaller as well as larger corporations.

The present law graduated rates for lower income corporations are intended to encourage growth in small business by easing the tax burden on such businesses.

Some argue that there is no economic rationale for retaining lower rates for low-income corporations. They contend that the ability-to-pay concept underlying the progressive individual rates is not applicable to corporations because corporate income is used for reinvestment or payment of dividends rather than for direct individual consumption needs. They also argue that the graduated rate structure may discourage mergers of small corporations that potentially could exploit economies of scale and raise productivity. Some also contend that owners of small corporations are in many cases relatively affluent individuals who may be better off having income taxed at lower corporate rates than at their regular individual rates, and that small corporations with 35 shareholders or less may elect to be taxed as an S corporation, in which case there is no corporate-level income tax and corporate income is taxed directly to the shareholders at their tax rates.

The availability of the graduated corporate rates and of a top corporate rate lower than the top individual rate has made it necessary to provide complex rules to prevent the proliferation of low tax brackets through the use of commonly controlled multiple corporations and to maintain certain sets of rules aimed at preventing the use of corporations to avoid the individual tax rates. These latter provisions, especially the personal holding company tax, were originally enacted in large part to prevent individuals from avoiding the individual rates at a time when the top individual rates were substantially higher than the corporate rates. Under present law, the top individual rate is 50 percent and the top corporate rate is 46 percent. Under the Administration proposal, the top individual rate is 35 percent and the top corporate rate is 33 percent. Use of the graduated corporate rates by individuals in the top income tax bracket could produce additional tax savings to the extent of undistributed corporate income. A main function of provisions such as the personal holding company tax under the Administration proposal would be to limit such use of the graduated corporate rates.

The 1984 Treasury Report would have contained the same two point differential in the top individual and corporate rates as does the Administration proposal, but did not provide graduated corpo-

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[1a] Under the 1984 Treasury proposal, the tax rate applicable to corporations with taxable income below $155,770 would increase, while the tax rate applicable to corporations with income equal to or greater than $155,770 would decrease.

rate rates and would have repealed the personal holding company tax.

Some have suggested providing a top corporate rate equal to the top individual rate. Others contend that a lower top corporate rate is appropriate to relieve double taxation of corporate income (see Part II, infra). Some suggest that the benefit of favorable corporate rates could be used as an incentive to certain goals. For example, proponents of broader employee ownership of corporations have suggested favorable lower rates for corporations with a specified percentage of employee ownership, or with progressively increasing employee ownership, as one of several possible incentives.[2]

[2] See separate Joint Committee on Taxation staff pamphlet, *Tax Reform Proposals: Tax Treatment of Employee Stock Ownership Plans (ESOPs)* September 1985.

II. THE TWO-TIER TAX ON DISTRIBUTED INCOME AND CERTAIN EXCEPTIONS—PROPOSALS REGARDING DIVIDEND DEDUCTIONS

Present Law and Background

In general

Under present law, corporations and their shareholders generally are separate taxable entities. A corporation's taxable income is subject to a corporate income tax at graduated rates with a maximum 46 percent rate for taxable income exceeding $100,000. Distributions by a corporation to its individual shareholders, to the extent of the corporation's current and accumulated earnings and profits,[3] generally are taxable as ordinary income to the shareholders, at graduated rates up to 50 percent.[4] Thus, corporate income that is distributed to shareholders generally is subject to two tiers of tax.

In contrast, corporate income that is not distributed to shareholders is subject to current tax at the corporate level only. To the extent that income retained at the corporate level is reflected in an increased share value, the shareholder may be taxed at favorable capital gains rates upon sale or exchange (including certain redemptions) of the stock or upon liquidation of the corporation. If an individual shareholder retains stock until death, the appreciation can pass to the heirs free of income tax (sec. 1014).[5]

Various deductions and credits can reduce or eliminate the corporate level tax. Corporate income distributed as interest payments to creditors rather than as dividends to shareholders is not taxed at the corporate level, since the corporation generally may deduct interest payments (but not dividend payments) from its taxable income.

The deductibility (within reasonable limits) of funds paid as salaries to shareholders who are also employees, reduces corporate tax and involves current taxation of the payment to the shareholder.[6]

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[3] Earnings and profits (sec. 312) are a measure of a corporation's economic income that frequently exceeds a corporation's taxable income. See discussion of earnings and profits in Part V., *infra*.

[4] Distributions with respect to stock that exceed corporate earnings and profits are not taxed as dividend income to shareholders but are treated as a tax-free return of capital that reduces the shareholder's basis in the stock. Distributions in excess of corporate earnings and profits that exceed a shareholder's basis in the stock are treated as amounts received in exchange for the stock and accordingly may be taxed to the shareholder at capital gains rates.

[5] In addition, in the case of certain corporate distributions in liquidation or in certain redemptions, unrealized appreciation in corporate assets can escape corporate tax entirely (apart from the recapture of specified items, such as certain prior depreciation deductions). In such cases, only a capital gains tax at the shareholder level may be imposed on the appreciation when the assets are distributed to the shareholders or sold to a third party and the proceeds distributed. The absence of taxation at the corporate level in these circumstances is discussed in Part III, below.

[6] It is possible that salaries of some shareholder-employees may be inflated to some extent within a range of asserted reasonableness, leaving little or no reported taxable income at the corporate level.

Other provisions that may affect corporate taxable income include preferential accounting methods and tax preferences under the Code that are intended as investment incentives, such as the investment tax credit, accelerated depreciation, and the exemption of interest on State and local obligations. Utilization of such provisions can reduce or eliminate the corporate level tax without requiring distributions to shareholders or otherwise resulting in current recognition of the income at the shareholder level. Corporations are subject to an "add-on" minimum tax on certain tax preferences.[7]

Certain Code provisions are designed to prevent unreasonable accumulations of corporate earnings (sec. 531 *et seq.*) or to cause the distribution of corporate earnings of "personal holding companies" to shareholders (sec. 541 *et seq.*). However, the provisions relating to unreasonable accumulations generally depend upon taxable income (with certain adjustments) and thus do not affect accumulations when a corporation is able to reduce its taxable income with certain preference items such as accelerated depreciation. The provisions intended to cause distributions of personal holding company earnings also generally depend upon taxable income and further apply only to certain closely held corporations that derive a substantial portion of their income from generally passive investments or certain personal services provided by shareholders.[8]

Exceptions

There are several departures in present law from this general scheme of corporation and shareholder taxation. Certain corporations are given direct relief from the corporate tax. Relief from taxation at the shareholder level is given in certain circumstances.

Relief from the corporate level tax

In general, direct relief from the corporate income tax is given to income earned by corporations electing under subchapter S ("S Corporations"), regulated investment companies ("RICs") (such as mutual funds), and real estate investment trusts ("REITs").[9] Income earned by an S corporation is allocated among and taxed directly to its shareholders regardless of whether such income is distributed. Income earned by a RIC or a REIT is subject to a tax at the corporate level, but both RICs and REITs are permitted deductions for dividends paid, in effect eliminating the corporate tax on earnings that are distributed. Moreover, in order to maintain

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[7] The corporate minimum tax is discussed in a separate pamphlet, Joint Committee on Taxation, *Tax Reform Proposals: Tax Shelters and Minimum Tax* (JCS-34-85), August 7, 1985.

[8] The Internal Revenue Service has ruled that certain corporate income from shareholder personal services is not subject to personal holding company tax, even though the client or customer may expect only the shareholder to perform the service, if someone else might theoretically be called upon to perform it. *See* Rev. Rul. 75-67, 1975-1 C.B. 169; Rev. Rul. 75-250, 1975-1 C.B. 172. A corporation earning only such income from the performance of services by its shareholders (for example, a professional corporation whose business consists of a shareholder performing medical services) could earn income subject to the graduated corporate rates and generally could accumulate a total of at least $150,000 without being subject to the accumulated earnings tax.

[9] S corporations are corporations that meet restrictions on the number of shareholders and certain other requirements and that also elect special treatment under Subchapter S. RICs and REITs are entities that derive a substantial portion of their income from essentially passive investments and that absent special provisions in the Code would otherwise be taxed as ordinary corporations. These entities are discussed further in Part IV below.

their status as a RIC or a REIT, such entities are required to distribute most of their income currently.

Direct relief from the corporate tax is also granted to cooperatives subject to subchapter T of the Code. In general, such cooperatives are also subject to tax at the corporate level but are given deductions for dividends paid out of profits derived from transactions with their members. Additionally, a cooperative may exclude income attributable to qualified per-unit retain allocations and redemptions of nonqualified per-unit retain certificates.

Only amounts paid within 8-1/2 months of the close of the cooperative's taxable year are entitled to this special treatment. As a result, cooperatives generally pay corporate tax only on profits that are not distributed, and on profits not derived from transactions with members.[10] Cooperative members who receive dividends will treat the dividends as income, reduction of basis, or some other characterization that is appropriate based on the nature of the members' transactions with the cooperative.[11]

Additionally, certain dividends paid with respect to stock held in an employee stock ownership plan and distributed to plan participants are deductible by the corporation (sec. 404(k).[12]

Common to these areas of direct relief from the corporate income tax generally is a concept of current taxation at the shareholder (or member) level of income that is not taxed to the corporation.

Relief from the shareholder level tax

Individual shareholders.—Under present law, the first $100 of qualified dividends received by an individual shareholder ($200 by a married couple filing jointly) from domestic corporations is excluded from income (sec. 116). Thus, to this limited extent, distributed corporate earnings are subject to tax at the corporate level only.

The dividends exclusion for individuals does not apply to dividends received from a tax-exempt organization (under section 501), a farmer's cooperative, a REIT, or a mutual savings bank (that received a deduction for the dividend under section 591), or to an ESOP dividend for which the corporation received a deduction. The exclusion is limited with respect to dividends received from a RIC.

Under the Economic Recovery Tax Act of 1981, a limited amount of dividends in the form of stock of certain public utility corporations, paid prior to January 1, 1986, are exempt from shareholder tax; absent this special rule, such dividends would otherwise be taxable because the shareholder has elected to receive the stock in-

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[10] In addition, tax-exempt farmers' cooperatives qualifying under section 521(b) of the Code may may receive additional relief from the corporate level tax since they may deduct patronage dividends paid to the full extent of their net income and also may deduct, to a limited extent, dividends on common stock.

[11] In some instances, cooperatives may operate on a "federated" basis, i.e., local cooperatives are patrons of other cooperatives operating on a regional or national basis. These cooperatives (and their individual patrons) may have different taxable years. This fact combined with the rule permitting patronage dividends to be deducted if paid within 8-1/2 months after close of a cooperative's taxable year can result in patronage earnings being distributed to a lower-tier cooperative and subsequently to an individual patron (generally the only party who is taxed on the income) in a taxable year subsequent to the year in which the income is earned.

[12] Employee stock ownership plans are discussed in a separate pamphlet prepared by the staff of the Joint Committe on Taxation.

stead of other property (sec. 305(e)). In effect, such amounts are not subject to shareholder tax if reinvested in the corporation.[12a]

Corporate shareholders.—Under present law, subject to certain exceptions, corporate shareholders receiving dividends generally are entitled to a deduction of 85 percent of the dividends received (sec. 243). Under the present 46 percent maximum regular corporate tax rate, the deduction means that the maximum corporate rate on dividends received from another corporation is 6.9 percent (.46 x (1-.85)). Dividends received from certain members of an affiliated group are eligible for a 100 percent dividends received deduction. In addition, pursuant to Treasury regulations, dividends received by one member of an affiliated group filing a consolidated return from another member of the group are not taxed currently to the recipient.

However, dividends received from another member of a consolidated group from pre-affiliation earnings and profits (deemed reflected in basis) or from post-consolidation earnings and profits that have increased the basis of the parent corporation's stock in the subsidiary, reduce the basis of the recipient corporation's stock in the payor subsidiary. (Treas. Reg. sec. 1.1502-32.)

In addition, any corporate shareholder's basis in shares with respect to which an "extraordinary dividend" was received may be reduced by the amount of the dividend that was not taxed unless the stock has been held for more than one year (sec. 1059). An "extraordinary dividend" is a dividend exceeding 10 percent of the basis of such common stock with respect to which the dividend was paid, or 5 percent of the basis of such preferred stock. Certain dividends are aggregated for this purpose.

The dividends received deduction is available whether or not the dividends represent earnings that were taxed to the the distributing corporation.

The dividends received deduction does not apply to certain dividends, including dividends received from a REIT, and the availability of the dividends received deduction is limited with respect to dividends received from a RIC.

The dividends received deduction is also not available with respect to dividends received on stock that is not held (with a substantial risk of loss) for a specified period, generally more than 45 days (90 days in the case of certain preferred stock)(sec. 246). The deduction is also limited for dividends received on certain "debt-financed portfolio stock" (sec. 246A).

International aspects

Dividends paid by a U.S. corporation to foreign shareholders generally are subject to a 30-percent withholding tax (secs. 1441, 1442) and may be subject to tax in the recipient's country as well.[13] Var-

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[12a] However, stock received as an untaxed dividend under section 305(e) is treated as having a zero basis. Moreover, a shareholder who disposes of any stock of the distributing corporation within a year of the record date of such a distribution is treated as having disposed of the stock received as a dividend and the disposition is ineligible for capital gains treatment.

[13] Certain dividends from a U.S. corporation that earns less than 20 percent of its gross income from U.S. sources (an "80-20 company") are not subject to U.S. tax when paid to foreign shareholders (secs. 861(a)(2)(B), 871(a) and 881; Treas. Reg. sec. 1.881-2). The Administration proposal would eliminate this rule. The foreign tax aspects of the Administration proposal are dis-

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ious income tax treaties substantially reduce the rate of the U.S. withholding tax, however.

In the case of foreign investment in U.S. corporate equity, corporate income is taxed at the corporate level (by the United States) and, on distribution, at the shareholder level (by the United States and perhaps another country), thus generally producing a two-tier tax on corporate income.

In general, dividends received by a U.S. corporation from a foreign corporation are not eligible for the dividends received deduction, even though the foreign corporation may have paid U.S. tax. However, where at least 50 percent of a foreign corporation's gross income is effectively connected with a U.S. trade or business, a portion of the dividends paid by such corporation to a U.S. corporate shareholder is eligible for the dividends received deduction. That portion generally is based on the percentage of the foreign corporation's income that is effectively connected with its U.S. trade or business (sec. 245).

Administration Proposal

In general

Under the Administration proposal, a domestic corporation would be entitled to a deduction equal to 10 percent of the dividends paid from earnings that have borne the regular corporate tax. The deduction would not be available to corporations that otherwise are subject to special tax regimes, e.g., regulated investment companies and real estate investment trusts.

Distributions that are not treated as dividends would not be eligible for the deduction. However, distributions that are not dividends in form but are so treated for income tax purposes (e.g., certain pro rata stock redemptions) would be eligible for the deduction. In addition, the dividends received deduction for corporations would be changed from the present law 85 percent or 100 percent based on the degree of stock ownership, to 90 or 100 percent based on whether or not the payor is entitled to the dividends paid deduction (without regard to the degree of stock ownership).

Under the Administration proposal, the dividends paid deduction would be treated like an ordinary business deduction for the purpose of determining the corporation's income tax liability, including the liability for estimated tax payments.[14] Net operating losses attributable to the dividends paid deduction would be available to be carried back and forward to the extent permitted by present law.

The qualified dividend account

Under the Administration proposal, which would generally be effective on January 1, 1987, dividends would be eligible for the dividends paid deduction only to the extent that such dividends do not

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cussed in a separate pamphlet, Joint Committee on Taxation, *Tax Reform Proposals: Taxation of Foreign Income and Foreign Taxpayers* (JCS-25-85), July 18, 1985.

[14] The Administration proposal does not discuss the effect of the dividends paid deduction on a corporation's earnings and profits. It would appear that the amount of the dividends paid deduction should not itself reduce earnings and profits, which would be reduced by the full amount of a dividend, whether or not deductible.

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exceed the amount of a "Qualified Dividend Account" ("QDA"). Generally, the QDA consists of the amount of corporate earnings that have been subject to the corporate tax for taxable years beginning after 1986, less the amount of deductible dividends paid. Dividends paid after 1986 in taxable years beginning before 1987 would be treated for purposes of the deduction as having been paid during the first taxable year beginning after 1986.[14a]

Accordingly, each year a corporation would add to its QDA its taxable income (i.e., gross income less deductible expenses), subject to certain adjustments.[15] For this purpose, taxable income would not include amounts on which no corporate tax was paid as a result of any available credit (including the foreign tax credit).

For example, suppose a U.S. corporation had $200,000 of gross income from operations, $100,000 of deductions, and $50,000 of tax-exempt interest income. Some or all of the deductions may be attributable to tax preference items that grant tax deductions in excess of economic expense. The corporation's initial tax liability (assuming a flat 33 percent rate for ordinary income) would be $33,000 (i.e., net taxable income of $100,000 times 33 percent). Assume the amount of tax it ultimately pays is $17,000 after applying a $10,000 investment tax credit and a $6,000 foreign tax credit. The corporation would add $51,515 to its QDA, an amount which is equal to the $100,000 total of the corporation's taxable income less the amount that if granted to the corporation as a deduction would yield the same tax benefit as the $16,000 in credits that the corporation used to reduce its tax liability (i.e., $16,000 divided by .33).

The amount of dividends paid in a taxable year would be deducted from the balance of the QDA as of the end of the taxable year, except to the extent that the balance in the QDA would be reduced below zero. Dividends in excess of the QDA as of the end of the taxable year in which the dividends were paid would not be deductible. Moreover, such "excess dividends" could not be carried forward and deducted after amounts were added to the QDA in subsequent years. Appropriate rules would provide for the treatment of the QDA in merger or acquisition transactions.[16]

Nondividend distributions

Whenever a transaction is treated as a dividend for Federal income tax purposes, the corporation would generally be entitled to a deduction and required to adjust the QDA to the same extent as if an actual dividend distribution were made. Thus, for example, for purposes of the dividends paid deduction, the corporation generally would be treated as having made dividend distributions to the extent that certain redemptions (sec. 302), certain stock purchases

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[14a] For example, if a corporation that uses a fiscal year deduction ending June 30 pays dividends on January 1, 1987, dividends would be eligible for the dividends paid only to the extent of income added to the QDA for corporation's fiscal year ending June 30, 1988.

[15] For this purpose, corporate income added to the QDA would be computed without regard to the dividends paid deduction in order to reflect the earnings available for distribution. The treatment of the dividends received deduction for this purpose is discussed under "Treatment of intercorporate distributions", *infra*. *See* n.19, *infra* regarding certain retroactive adjustments to taxable income such as net operating loss carrybacks or audit adjustments.

[16] The Administration proposal does not discuss such rules. Presumably, the QDA in this case could be treated as a "tax attribute" that is carried over in accordance with the provisions of section 381. It is unclear whether there would be a need for special limitations similar to those of section 382 to prevent trafficking in QDA's.

by a related corporation (sec. 304), certain redemptions of preferred stock (sec. 306), and certain distributions of boot in reorganizations (sec. 356) are treated as dividends.

To be permitted to take the deduction, however, the corporation must treat the distribution as a dividend for information reporting purposes. Where any such transaction is not initially treated as a dividend but is later so characterized, the Internal Revenue Service would be authorized to allow the deduction, provided the corporation and the shareholder treated the deduction consistently.

Appropriate adjustment to the QDA would be made for certain nondividend distributions. In the case of complete liquidations, the QDA would be eliminated completely.[17] In the case of redemptions or partial liquidations, the QDA would be reduced proportionately with the amount of stock redeemed or portion of the stock liquidated, but not in excess of the amount of redemption or liquidation proceeds distributed to shareholders. This is analogous to the treatment under present law of the earnings and profits account upon redemptions or partial liquidations.

Treatment of intercorporate distributions

Under the Administration proposal, a corporation would be entitled to the 10 percent dividends paid deduction without regard to whether the shareholder-payee is an individual or a corporation.

Where a corporate shareholder receives a dividend with respect to which the payor corporation is entitled to a dividends paid deduction, such shareholder would be entitled to a 90-percent dividends received deduction. Although the corporate recipient generally would be taxed on only 10 percent of the dividends it receives, it would increase its QDA by the full amount of any such dividends. Thus, on redistribution of that amount to its shareholders, it would in turn be entitled to the 10-percent dividends paid deduction.

Where a corporate shareholder receives a dividend with respect to which no dividends paid deduction was available (because the distributing corporation did not pay any corporate tax on the distributed earnings), such shareholder would be entitled to a 100-percent dividends received deduction.[18]

The extent of the shareholder's ownership of the distributing corporation would not affect the amount of the dividends received deduction as it does under present law.

Under the Administration proposal, corporate earnings would be taxed no more than once prior to distribution to non-corporate shareholders.

To implement these rules, the payor corporation would be required to report to its corporate shareholders the amount of the

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[17] The Administration proposal does not discuss whether this treatment would apply to liquidations of controlled subsidiaries qualifying for nonrecognition treatment under section 332. A corporation's QDA in this situation could be treated as a "tax attribute" that is carried over to the shareholder corporation under section 381. *See* n.16, *supra.*

[18] The Administration proposal does not directly address the treatment of the recipient corporation's QDA in the case of dividends eligible for the 100 percent dividends received deduction. It would appear that there should be no adjustment to the recipient's QDA on account of such dividends paid out of untaxed income (i.e., neither the dividend nor the deduction should be reflected in the QDA). Otherwise, the recipient would build up its QDA with respect to amounts that have borne no corporate tax at any level.

dividends paid to such shareholders with respect to which a dividends paid deduction was allowed to the payor corporation.[19]

The Administration proposal would not alter any of the provisions of current law that deny the dividends received deduction in certain circumstances (e.g., sec. 246). Accordingly, in such circumstances, the full amount of the dividend would be taken into account in computing the recipient corporate shareholder's taxable income, no dividends received deduction would be allowed to the shareholder and no special rules would be used to compute the shareholder's QDA. The payor corporation, if otherwise eligible, could obtain the 10 percent deduction for the dividend paid.

Treatment of foreign corporations and foreign shareholders

Under the Administration proposal, a U.S. corporation would be entitled to the dividends paid deduction without regard to whether the dividends were paid to domestic or foreign shareholders. However, those foreign shareholders who do not benefit from a treaty entitling them to a limitation on the U.S. dividend withholding rate would be subject to an additional withholding tax on dividends from a U.S. corporation. The additional tax would equal the benefit received by the U.S. corporation on account of the dividends paid deduction. Thus, there would be imposed an additional withholding tax equal to 3.3 percent of the amount of dividends with respect to which a dividends paid deduction was allowed.[20]

At least initially, the additional withholding tax would not be imposed on dividends paid to foreign shareholders entitled to a maximum withholding rate on dividends under a treaty. All U.S. income tax treaties presently in force establish such a maximum rate of tax. However, authority would be reserved for the Treasury Department to impose the compensatory withholding tax on dividends paid to shareholders in any treaty country that grants relief from a domestic two-tier tax to its national shareholders but not to U.S. shareholders.

Under the Administration proposal, the dividends paid deduction would be allocated between U.S. and foreign source income. The proposal states that the allocation to a particular source would be proportionate to the amount of earnings from the particular source in the QDA out of which the dividend was paid.

A foreign corporation would not be entitled to the dividends paid deduction under the Administration proposal. However, the dividends received deduction allowable under present law with respect to dividends received by a domestic corporation from a foreign corporation's earnings subject to U.S. corporate income tax would be increased to 100 percent of such dividends received.

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[19] The Administration proposal does not discuss the effect of net operating loss carrybacks or other subsequent year adjustments (such as audit adjustments) that may retroactively reduce (or increase) the QDA and eliminate (or create) a payor corporation's dividends paid deduction. Such adjustments could retroactively affect a recipient corporation's dividends received deduction. Appropriate rules would have to be developed to address this situation, taking into account administrative difficulties that may arise if payor corporation adjustments would require adjustments to the tax liability of all recipient corporations.

[20] The benefit of the deduction to the corporation equals 10 percent of the dividend times the 33 percent corporate rate, or 3.3 percent of the dividend.

Treatment of individual shareholders

Under the Administration proposal, the limited dividends received exclusion for individuals would be repealed.

Other Proposals

Several alternatives might be considered as a means of lessening or eliminating the burden of the two-tier taxation of income earned by corporations.

1984 Treasury Report

The 1984 Treasury Report proposed a dividends paid deduction and a corresponding dividends received mechanism generally similar to that in the Administration proposal, except that 50 percent rather than 10 percent of dividends paid would have been eligible for the deduction.

Shareholder credit

An alternative to a dividends paid deduction is a mechanism that would give shareholders an income tax credit to reflect all or a portion of the corporate level tax paid with respect to the dividends received. The amount of the credit could be adjusted based on the degree to which partial relief from the two-tier tax is desired.[21] Under such a system, shareholders who receive dividends could "gross up" the dividends by the amount of the credit for corporate taxes paid, and include the grossed-up amount in income while using the credit as an offset to their tax liability.

Credit systems, also known as "imputation systems," are used by several foreign countries including West Germany, France, Canada, Japan, and the United Kingdom. A number of these countries grant the shareholder credit only to the extent the corporation has actually paid tax on dividends.

An approach involving a nonrefundable shareholder credit was proposed by Chairman Ullman of the House Committee on Ways and Means in 1978.[22]

Full integration: Deemed distribution and reinvestment of corporate earnings

Relief from the two-tier tax also could be achieved by eliminating the corporate level tax but allocating undistributed earnings currently among the shareholders. Under this approach, a corporation's undistributed earnings would be deemed to have been distributed to and reinvested by the shareholders each year. Tax could be collected at the corporate level, in effect using the corporation as a withholding agent for the shareholders, or tax could be collected solely at the shareholder level without withholding. Shareholders would be subject to income tax on the allocated earnings and would adjust their basis in their shares accordingly.

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[21] Like the dividends paid deduction, the mechanism for implementing a shareholder credit system could be designed to ensure that the credit is available only with respect to corporate earnings that have been taxed. *See* the discussion under "Treatment of tax preference items", *infra*.

[22] *See* 124 Cong. Rec. H2337 (March 22, 1978).

In one form of this mechanism, all corporations could be treated in a manner similar to either partnerships or S corporations; this treatment could include the passing through of credits and losses. Other versions could provide for the passthrough of net income but not losses in excess of income, as is the case with REITs. This form of relief from the two-tier tax is known as "full integration" since the separate corporate level tax is eliminated with respect to all corporate earnings, rather than distributed earnings only.

Lowering corporate taxes

Lowering corporate taxes, either by lowering corporate taxes generally or by granting or increasing certain preferences, has been suggested as possible means of reducing the burden of the two-tier tax on corporate income.

ALI Reporter's Study

A *Reporter's Study on Corporate Distributions* was published as an Appendix to the American Law Institute's *Federal Income Tax Project, Subchapter C, Proposals on Corporate Acquisitions and Dispositions* (1982).[22a] The Reporter's study made three specific proposals relating to the two-tier taxation of corporate income. The proposals would (1) provide a deduction for dividends paid on new corporate equity, (2) impose a compensatory excise tax on nondividend distributions, and (3) modify the tax treatment of intercorporate investment and distributions.

The Reporter's first proposal would permit a corporation to deduct dividends allocable to new equity (i.e., shares issued after the proposal becomes effective) generally to the same extent that distributions would have been deductible if debt instead of equity were issued. The corporation would apply an assumed rate of interest to the amount of new equity raised and a deduction would be permitted for dividends paid up to this amount (even though paid to old as well as new shareholders). At the same time, the deductions for interest on new debt from 10 percent or greater shareholders generally would be limited to the same assumed rate utilized in computing the dividend deduction. By focusing on new equity only, this proposal attempts to lessen any bias in favor of new debt financing over new equity, while limiting the revenue impact and potential redistributional effect of dividend relief on all preexisting equity.

The Reporter's second proposal would, in general, impose a compensatory excise tax on corporations making nondividend distributions in excess of amounts of new equity capital raised. The excise tax would compensate for the fact that in nondividend distributions (generally taxed to shareholders at preferential capital gains rates or as a tax-free recovery of basis), assets have been freed from the burden of the corporate tax without having borne tax at ordinary income rates at the shareholder level. The Reporter's study notes that such distributions are the economic equivalent of dividend distributions followed by the purchase and sale of shares among shareholders. Limiting the excise tax to nondividend distributions

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[22a] The proposals contained in the Reporter's Study have not been adopted by the American Law Institute.

in excess of new equity capital is intended to be consistent with the first proposal in treating new equity and debt similarly.

The Reporter's third proposal would distinguish between a corporate shareholder's portfolio and direct investments. Any investment in a majority of the common stock of an issuer for a year would be a direct investment; any investment in 10 percent or more of the common stock of an issuer could electively be designated as a direct investment; other investments would be portfolio investments. The proposal would deny a corporate shareholder deductions for dividends received on portfolio investment. Payment for the corporate acquisition of any direct investment (which could still qualify for the deduction) would be treated as a nondividend distribution subject to the excise tax imposed by the second proposal. The proposal notes that such acquisitions could have an effect comparable to redemptions, i.e., the distribution of corporate earnings outside of a corporation without being taxed as dividends.[23] The proposal would also deny a corporate shareholder deductions for dividends received on a direct investment until the time at which the dividends were redistributed.

Modification of the dividends received deduction

Whether or not a dividends paid deduction is implemented, certain modifications to the dividends received deduction (other than those contained in the Administration proposal) could be made. The most extreme option would be the elimination of the deduction (subject to appropriate transition rules). A somewhat less extreme option (as proposed by in the Reporter's Study Appendix to the ALI Subchapter C Proposals) would be elimination of the deduction for portfolio investment. Another option would be limiting the dividends received deduction to dividends that are paid out of earnings that have been subject to corporate tax. Others have suggested allowing the deduction for the lesser of dividends received or paid by the corporation during the year.[24]

Some have suggested requiring a recipient corporation to reduce its basis in the stock of a distributing corporation by the amount of dividends excluded from the recipient's income because of the dividends received deduction, or possibly requiring reduction of such basis only for purposes of determining losses on the ultimate sale of the stock, at least in some circumstances beyond those covered by section 1059.

Analysis

In general

Considerable disagreement exists about the role of the corporate income tax in the U.S. tax system. Many favor the treatment of

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[23] The Reporter's proposal notes that this could occur since assets (in the form of the payment made by the acquiring corporation to the other corporation's shareholders) are removed from corporate solution (of the acquiring corporation) and placed in the hands of the selling shareholders, while the acquiring corporation (unlike the selling shareholders) would be entitled to a dividends received deduction for distributions from the acquired company.

[24] A similar but somewhat more complex approach was discussed by the Treasury in 1983 Testimony. *See* Testimony of Ronald A. Pearlman, Deputy Assistant Secretary (Tax Policy), Department of the Treasury, in "Reform of Corporate Taxation," Hearings before the Committee on Finance, United States Senate, 98th Cong., 1st Sess. (October 24, 1983), at pp. 38–40.

corporations as entities separate from their shareholders along with the imposition of separate unintegrated taxes on income earned by corporations and on dividends distributed to shareholders. Others, however, contend that the separate taxation of corporations and their shareholders has undesirable economic effects that should be alleviated by providing some relief from the two-tier tax.

Revenue considerations, perception of the corporate entity, and speculation about the economic effects of a separate corporate level tax, including "who pays the tax" and what economic decisions may be influenced by the existence of the tax, all play a role in the debate on this issue.

Arguments in favor of two-tier tax

Advocates of the two-tier tax generally argue that the corporate tax not only is a source of revenue that might not easily be replaced if the corporate tax were eliminated either directly or indirectly, but also is a tax imposed on an appropriate income base. Imposing a separate corporate income tax is supported by those who view corporations as vehicles for accumulating capital that are entities distinct from the individuals who contributed the capital and who enjoy limited liability with respect to the corporation's obligations and activities.

In many cases, corporations are viewed as not being effectively controlled by shareholders but rather by the corporate officers and directors. It is argued that it is appropriate to treat the earnings on accumulations of capital in such circumstances as a proper base of taxation.[25] In contrast, certain corporations that may be considered as directly controlled by shareholders are permitted to elect treatment under subchapter S, which permits the S corporation to avoid being taxed as a separate entity.[26]

Another argument for the imposition of a separate corporate tax is that it is a necessary "backstop" to the individual income tax in the case of retained earnings. Without either a deemed distribution system analogous to the S corporation model or a substantial corporate tax, income could be accumulated without bearing adequate income tax compared to the amount of tax that would be paid if the income were earned directly by individuals.

For example, if there were either no corporate tax or a corporate tax imposed at a much lower rate than the individual tax, individuals would be able to invest assets in corporations where these assets would earn and accumulate income that was not taxed currently (or only taxed at low rates currently). Such income earned by corporations, to the extent reflected in increased value would be taxed on a deferred basis to the individuals, perhaps at capital gains rates or perhaps not at all in the case of an individual who holds appreciated shares of stock at death (sec. 1014). Thus, some

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[25] *See* Richard Goode, *The Corporation Income Tax* (Wiley, 1951), pp. 24-43; Joseph A. Pechman, *Federal Tax Policy* (Brookings Inst., 4th ed, 1983), p. 130.

[26] Extension of the S corporation model of taxation to other corporations could be viewed as imposing current tax on shareholders with respect to income the distribution of which they do not effectively control. The burden of such an approach could be alleviated if the tax is collected for the shareholders out of corporate funds, as a withholding tax, but differences in the effective rates of shareholders could involve complexity.

contend that absent full integration, the imposition of a substantial corporate tax on undistributed corporate earnings is at a minimum justified in order to prevent deferral or complete avoidance of taxation of the income earned through corporations.[27]

Any need for a current corporate tax approximating individual rates on accumulated earnings in order to "backstop" the individual tax and compensate for deferral of individual tax is not, however, necessarily undermined by the granting of relief from the corporate tax on distributed income since the distributed income generally would be taxable immediately to the recipient shareholders, thereby ending any deferral. Some opponents of relief from the two-tier tax may nevertheless contend that the separate tax should be retained without relief even on distribution of earnings, to compensate adequately for deferral that may occur to the extent that an individual's effective rate may exceed a corporation's effective rate. Some also contend that given the distribution of ownership of corporate equity, the two-tier tax adds to the progressivity of the income tax system, and that relief from the two-tier tax would disproportionately benefit wealthy taxpayers.

In addition, some have argued that a two-tier tax system is an appropriate method of preventing tax evasion and shelter activity and otherwise promoting compliance. For example, it has been suggested that tax evasion and tax shelter activity with respect to any particular tax may be greater with higher marginal rates. This observation has led to the suggestion that a two-tier tax with lower rates at each tier rather than a higher-rate single-tier tax is preferable from the standpoint of compliance and avoiding incentives to shelter income.[28]

It has also been argued that countries that have adopted some form of relief from the two-tier tax have done so for reasons unrelated to any theoretical preference for a "conduit" view of the corporation and individual income taxes, e.g., France to stimulate its capital markets and Canada to promote domestic ownership of industry.[29]

Arguments for relief from the two-tier tax

Advocates of relief contend that the relationship of the separate corporate and individual income taxes tends to create certain distortions in economic decisions that should be alleviated by providing some form of relief from the two-tier tax.[30] Such advocates generally contend that the tax system should seek to provide (a) neutrality between corporate and noncorporate investment, (b) neutrality between debt and equity financing at the corporate level, and (c) neutrality between retention and distribution of corporate earnings.

One concern that has been expressed is that the two-tier tax may discourage some from deciding to carry on business in corporate

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[27] *See* Pechman, n. 25, *supra*.

[28] *See* Marks, "Tax Income Again and Again," *Wall Street Journal*, June 24, 1985, p. 18.

[29] *See* Surrey, "Reflections on 'Integration' of Corporation and Individual Income Taxes," 28 *National Tax Journal* 335, 335 n.2 (Sept. 1975).

[30] For discussion with analysis of the various possible effects of the two-tier tax, *see, e.g.*, Warren, "The Relation and Integration of Individual and Corporate Income Taxes," 94 *Harv. L. Rev.* 719, 721-738 (1981).

form in situations where nontax considerations indicate that corporate operations would be preferable. The extent to which this may occur depends in large part upon where the corporate tax ultimately falls. As discussed below, there are differing views of the extent to which the burden of the corporate tax is in fact borne by shareholders rather than "passed on" to consumers or employees of corporations. A related concern is that to the extent alternative forms of operation are available that offer some of the advantages of a corporation without the burden of corporate tax (such as a limited partnership), taxpayers effectively can elect whether or not to subject themselves to the corporate tax in any event.[31]

Another concern is that the two-tier tax in its present form may encourage financing corporate investment with debt rather than new equity, because deductible interest payments on corporate debt reduce corporate taxes while nondeductible dividends do not.

For example, if an individual in the 50 percent marginal tax bracket invests $1,000 in a corporation as equity, and the corporation, subject to a 46 percent tax rate, earns a 10 percent ($100) pre-tax return, there will be only $54 available after corporate tax for distribution and the individual will have only $27 left after individual taxes on this distribution. The total tax on the $100 of earnings is $73 (73 percent). However, if the individual lends $1,000 to the corporation at 10 percent interest, the corporation can deduct the full $100 interest payment so that no corporate tax is paid, while the $100 distribution is subject to a $50 (50 percent) tax in the hands of the individual (the same tax that would have been paid if the $100 were earned outside of corporate solution). Therefore, corporate earnings distributed as dividends are subject to an additional 23 percent tax not borne by earnings distributed as interest.

Accordingly, there may be a incentive for an individual to structure an investment using a large amount of debt rather than equity. Similarly, from the point of view of the corporation and its existing shareholders, new equity from individuals is more costly than debt because greater pre-tax earnings are needed to provide the same market return to the new investor.

On the other hand, the corporate dividends received deduction (which is 85 percent for portfolio investment and can be 100 percent for direct investment) provides an incentive for a corporation to invest in stock rather than debt of another corporation. Furthermore, when an issuing corporation has tax losses so that the interest deduction provides no additional tax benefit, it may be able to issue to corporations preferred stock that mimics debt—for example, providing a floating dividend rate pegged to Treasury bill interest rates—effectively passing through some of the benefit of its losses to corporate shareholders.[32] It is not clear to what extent taxable corporations may respond to tax incentives to issue debt, while corporations that are unable to benefit from an interest deduction because of other tax losses may prefer to issue stock to corporate investors.

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[31] *See* the discussion of entity classification in Part V., below. For example, a profitable corporation that desires to distribute most of its earnings currently may seek to operate in limited partnership form to eliminate the corporate tax on such earnings.

[32] *See* discussion under "Treatment of intercorporate distributions—the dividends received deduction", *infra*.

To the extent that a two-tier tax results in a bias in favor of debt financing, the risk of bankruptcy is increased for corporations, particularly those in cyclical industries. Moreover, the importance of the distinction between debt and equity, both for individual investors and corporate issuers that would prefer investments to be characterized as debt, and for corporate investors and issuers that would prefer investments to be characterized as equity, also generates difficult legal problems in distinguishing between the two.[33]

A further issue is whether the two-tier tax distorts decisions to retain or to distribute corporate earnings. Where shareholders are better able than their corporation to put capital to its most productive use, then a tax-based disincentive to distribute earnings creates an economic inefficiency. Conversely, where a corporation is better able to invest capital than its shareholders, any incentive to distribute earnings also creates an inefficiency. Where the corporation and its shareholders are both able to make the best possible investments, no inefficiency necessarily would result from incentives to retain or distribute earnings. Advocates of relief from the two-tier tax contend that the present system is not neutral with respect to the distribution or retention of earnings, and that increased neutrality is desirable.

The two-tier tax on dividend distributions can make it more desirable for a corporation to use retained earnings, rather than new equity from individuals for its investments. Shareholders can find such earnings retention attractive (subject to the accumulated earnings tax and personal holding company rules) where the shareholder expects to realize the value of such reinvested earnings at preferential capital gains rates on an ultimate redemption or sale of the stock or liquidation of the corporation[34] or intends to hold stock until death, so that appreciation can be passed to his heirs free of individual income tax (sec. 1014).

There is also an incentive under present law to retain earnings if the corporation's current effective tax rate on undistributed earnings is lower than the shareholder's current effective rate on distributed earnings.[35]

On the other hand, where the effective tax rate of the shareholder is significantly lower than the corporate effective tax rate—for example, if the shareholder is a tax-exempt entity or is a corporation entitled to a dividends received deduction—there may be an incentive to distribute earnings.

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[33] Illustrative of the difficulties inherent in distinguishing debt from equity is the fact that in 1969, Congress authorized the Treasury Department to issue such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated as stock or debt (sec. 385). In the approximately 16 years since that time, the Treasury has issued and withdrawn several sets of proposed regulations, none of which has ever become effective.

[34] In liquidation, unrealized appreciation in corporate assets may remain untaxed at the corporate level while the shareholder obtains a stepped-up basis at the price of a capital gains tax only. *See* discussion in Part III., below. Advocates of relief from the two-tier tax also point out that the advantage of capital gains treatment for individual shareholders, and of dividend treatment for corporate shareholders, generates difficult legal issues in an attempt to determine whether a particular redemption or other distribution out of corporate solution should be treated as an ordinary income "dividend" or a capital gain "sale" transaction.

[35] Under present law, the top marginal ordinary income tax rate is 50 percent for individuals and 46 percent for corporations. The Administration proposes a top marginal ordinary income tax rate of 35 percent for individuals and 33 percent for corporations. The actual effective rates for a particular corporation or individual of course may vary further, depending, for example, on the availability of tax preferences or other deductions.

Issues regarding incidence of two-tier tax

There is considerable uncertainty about the economic effects of the two-tier tax or the extent of the possible distortions it may cause. While taxes are generally considered to provide a disincentive to savings and investment, there is little agreement concerning the effect of the two-tier tax on economic activity. One source of the uncertainty is the widely varying circumstances of corporations and their shareholders—differing effective tax rates, degree of ownership, behavioral assumptions, etc. Another source is lack of agreement about who bears the burden of the corporate tax either in the short run or the long run.

Many, especially those who favor relief from the two-tier tax, believe that the imposition of the two-tier tax reduces the rate of return for individuals on assets placed in corporate solution. If so, the tax is effectively borne by shareholders whose income then is considered to be overtaxed, with resulting disincentives for savings and investment in activities appropriately conducted in corporate form.

Others, however, believe that the imposition of the two-tier tax results in higher prices for products produced by the corporate sector of the economy, lower wages for workers in the corporate sector, or both, in order that an adequate return remains for the capital invested therein. Thus, to the extent that higher prices or lower wages result from the corporate tax, the burden of the tax is borne by either consumers or workers. To any such extent, the two-tier tax would not necessarily constitute a disincentive for investment in corporate form, although issues would remain relating to the neutrality of the tax system with respect to decisions about debt or equity financing and income retention or distribution.[36]

Some have suggested that relief from the two-tier tax should be granted only as an incentive for particular goals. For example, some proponents of broader employee ownership of corporations have suggested that relief for distributed earnings could be granted only when a corporation has a specified percentage of employee stock ownership, or has an increasing percentage of such ownership. Similarly, it has been suggested that the present law deductibility of interest be limited to situations where the debt is incurred to advance the desired goal.[37]

Method of granting relief

The 10-percent dividends paid deduction contained in the Administration proposal would be a modest step toward elimination of the two-tier tax. Assuming that the rate reductions in the Administration proposal are enacted, the effect of the dividends paid deduction would be to reduce the burden of the two-tier tax from 23 to 20 percentage points.[38]

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[36] Further, to the extent that the corporate tax is "passed on," it could not be said to contribute to the progressivity of the tax system.

[37] Employee stock ownership plans are discussed in a separate pamphlet prepared by the Staff of the Joint Committee on Taxation. *See* n. 2, *supra.*

[38] Under present law, where corporate earnings are taxed at a 46 percent rate and the after-tax earnings are distributed to an individual shareholder who is taxed at a 50 percent rate, the total taxation is 73 percent (.46 + .50(1-.46)) or 23 percentage points greater than a single share-

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In view of revenue needs and the existing uncertainty regarding whether a two-tier tax is inappropriate, some have questioned whether the modest reduction in the possible distortions that the Administration proposal affords in any particular case is worth the estimated five-year (fiscal years 1986-1990) aggregate revenue cost of $21.3 billion.[38a]

Others contend that some measure of relief from the two-tier tax is appropriate. In addition, some contend that the Administration's proposed mechanism for relief may establish an approach that could be expanded if further relief were desired in the future.

Assuming relief from the two-tier tax is considered desirable, a number of different mechanisms—of which the Administration's dividends paid deduction is one—could be considered.

Full integration

Full integration through a deemed distribution and reinvestment system is generally considered to be the most theoretically desirable method of providing the relief, since all income earned at the corporate level would be taxed directly and currently to the shareholders, leaving none of the possible distortions described above.

However, such a system is also considered to be difficult to implement. One traditional objection to this form of relief, concern that imposition of tax at individual rates on allocated corporate income may result in liquidity problems for shareholders whose marginal rates exceed the rate of tax collected at the corporate level, has been substantially diminished by the closer approximation of the top nominal corporate and individual tax rates, though the actual effective tax rate of a particular shareholder and a particular corporation might differ within the range up to the top nominal rates.

Nevertheless, considerable administrative difficulties are inherent in a system of full integration. For example, the need to allocate a corporation's tax attributes among all its shareholders (particularly in the case of a widely held public corporation the shares of which change hands frequently, and adjustments to whose tax attributes is commonplace), as well as the resulting need for individuals to account for potentially complex items such as foreign tax credits, intangible drilling costs and the like, pose what many consider to be insurmountable obstacles to the general implementation of this system.

Lowering corporate taxes

Lowering corporate taxes would reduce the extent of double taxation of corporate earnings. This method of affording relief from the two-tier tax could reduce concerns about incentives for debt financing and under investment in the corporate sector. However, such concerns would not be eliminated so long as there is a corpo-

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holder level tax of 50 percent. Under the Administration proposal, where corporate earnings are taxed at a 33 percent rate but the corporation receives a 10 percent dividends paid deduction, and the after-tax earnings are distributed to an individual shareholder who is taxed at a 35 percent rate, the total taxation is 55 percent ((.33-.033) + .35(1-(.33-.033)) or 20 percentage points greater than a single shareholder level tax of 35 percent.

[38a] Staff of the Joint Committee on Taxation, *Estimated Revenue Effects of the President's Tax Reform Proposal* (JCS-26-85), July 26, 1985.

rate level tax. Moreover, the lower the corporate effective tax rate relative to the individual effective tax rate, the greater the incentive will be for a corporation to retain rather than distribute earnings.

Dividends paid deduction vs. shareholder credit

The dividends paid deduction (proposed by the Administration) and the shareholder credit are generally considered the two most feasible methods of implementing some relief from the two-tier tax and are generally considered economic equivalents. They operate to provide relief only with respect to distributed income. The main economic distinction between the two methods (where a credit is refundable) is that the dividends paid deduction initially puts cash generated by the tax relief in the hands of the corporation, while an imputation system puts the cash in the hands of the shareholders.

The Administration proposal states that the dividends paid deduction is chosen primarily because the Administration considers it somewhat easier than an imputation system to implement. A dividends paid deduction requires no additional accounting by individual recipients of dividends, though it would impose some additional accounting and reporting requirements on a corporation paying dividends. A corporate recipient of dividends would also have accounting requirements that might prove difficult to administer, since accurate accounting for a recipient corporation's QDA may require adjustment to reflect subsequent adjustments in a payor corporation's income tax liability.

An imputation system would impose accounting and reporting requirements similar to those required for the dividends paid deduction on corporations paying and receiving dividends. However, it would also require individual shareholders to account for dividends differently, not simply by including them in income but by using the gross-up and credit calculation.

Nevertheless, an imputation system may offer some advantages over the dividends paid deduction if it is considered desirable to limit the relief in the case of certain shareholders—for example, foreign or tax-exempt shareholders. (*See* discussion under "International Aspects—Foreign shareholders" and under "tax-exempt shareholders", below.) Accordingly, despite the relatively small additional administrative burden placed on individuals, consideration may be given to use of an imputation system rather than a dividends paid deduction if relief from the two-tier tax is to be implemented.

Dividend exclusion for individuals

The Administration proposal would eliminate the present-law dividend exclusion for individuals. As discussed above, the dividend exclusion for individuals tends to benefit high-bracket taxpayers more than low-bracket taxpayers. A dividend credit system, as described above, could provide more equal benefits.

Moreover, according to the Treasury Department, over three quarters of individuals who report dividend income receive the benefit of the entire amount of the exclusion available under present law. For these individuals the exclusion does not lower the margin-

al income tax rate on dividend income, and thus it appears that the exclusion generally does not encourage additional investment in corporate equity in any significant way. Furthermore, the present dividend exclusion eliminates the tax-based incentives relating to debt or equity financing or the distribution or retention of earnings only to a minimal extent.

Treatment of intercorporate distributions—the dividends received deduction

Distributions out of untaxed earnings

Under the Administration proposal, the dividends paid deduction and the corporate dividends received deduction generally operate to relieve corporate level tax only when earnings are distributed and to ensure that intercorporate distributions do not result in additional corporate level tax.

Under the Administration proposal (as under present law), a corporate shareholder is entitled to a dividends received deduction even when the corporate earnings from which the dividends were paid bore no corporate tax. The proposal grants a 100 percent dividends received deduction in any such case, while present law would grant a 100 percent deduction in the case of certain direct investments and an 85 percent deduction in the case of portfolio investments.

To the extent that permitting a dividends received deduction for corporate shareholders is justified as a means of ensuring that earnings bear only one corporate tax, it may not be appropriate to permit a dividends received deduction where the effect of doing so is to prevent any corporate tax at all.

The ability to pass through losses through intercorporate stock investment can place additional pressure on distinctions between equity and debt. Under present law, preferred stock is often structured so that it has characteristics that make it very similar to debt. For example, the dividend rate on the stock may be related to prevailing interest rates but provide an after-tax yield that is more favorable to a corporate shareholder than fully taxable interest and less costly to the corporate issuer. Either public trading or a call feature (where there is an intention to call) might provide the holder of the preferred stock with access to the return of the advanced funds. A corporation with substantial net operating losses (and thus no current tax liability) may issue preferred stock to another corporation instead of issuing debt. Since the interest deductions on additional debt would not be of any immediate benefit to the issuing corporation, a benefit is effectively transferred to the purchasing corporation which receives dividend income that is 85 percent tax-free instead of fully taxable interest income. Thus, the issuance of preferred stock to a corporation may be considered a technique for transferring tax benefits.

Consideration could be given to limiting the availability of the dividends received deduction to amounts paid out of earnings that have been taxed. An account like the QDA might be used for the purpose of determining whether dividends are paid out of earnings that have been taxed, regardless of whether a dividends paid deduction is implemented.

On the other hand, some may contend that to the extent a corporation has funds available for distribution that have not been taxed and this is a result of tax incentives at the corporate level, the benefit of those incentives should be preserved and passed through as long as the earnings remain in corporate solution. (*See* discussion under "Treatment of tax preference items," below.)

Portfolio investment

Under the Administration proposal, the dividends paid and dividend received deductions operate to relieve corporate level tax on intercorporate distributions without regard to whether the distributee corporation is a mere portfolio investor or is a direct investor that could be viewed as effectively operating through the payee corporation. The Administration proposal is similar to present law in this respect, although present law does impose a maximum 6.9 percent ordinary income tax on intercorporate dividends on portfolio stock, while dividends to a direct corporate investor are not taxed.

Some contend that allowing corporate shareholders a dividends received deduction with respect to portfolio investment is contrary to the general treatment of corporations and shareholders as separate taxable entities. Furthermore, as noted above, given the ability to structure preferred stock so that it closely mimics debt, it is contended that the dividends-received deduction for portfolio investment may frequently permit loss passthroughs between otherwise unrelated corporations.[39]

Dividends received deduction and shareholder basis

Under present law, as under the Administration proposal, the basis of a corporate shareholder's stock in another corporation is not generally reduced when dividends that are excludable from the recipient's income are paid.[40]

Present law does require reduction of basis where certain "extraordinary dividends" are paid on stock held less than a year (sec. 1059). This rule, added by the Deficit Reduction Act of 1984, is intended to prevent certain "tax arbitrage" transactions. In these transactions, a corporation would buy stock of another corporation prior to a large dividend payment (at a purchase price reflecting the value of the dividend). The corporate stockholder would receive the dividend subject to a maximum 6.9 percent tax due to the dividends received deduction, retain its original stock basis, and then sell the stock, after the dividend, at a loss (reflecting a market decline of approximately the amount of the dividend) worth up to 46

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[39] In the past, Congress has limited the benefits of the dividends received deduction in certain cases. For example, in the Deficit Reduction Act of 1984, Congress added section 301(f), which provides that certain provisions of section 312 (relating to the computation of earnings and profits) would not apply with respect to distributions to certain "20-percent shareholders," where the effect of applying such provisions would tend to treat a greater amount of distributions as eligible for the dividends received deduction. That Act also added section 246A, which limits the availability of the deduction in certain cases where a corporate shareholder holds portfolio stock that was debt financed.

[40] Under Treasury regulations, in the case of affiliated corporations filing a consolidated tax return, the basis of a parent corporation's stock is generally reduced by dividends out of pre-affiliation earnings (deemed reflected in the parent's basis) or out of post-consolidation earnings and profits that have increased basis (Treas. Reg. sec. 1.1502-32).

percent in offsetting unrelated short-term capital gain income. The transaction could thus produce a net 39 percent tax benefit.

There may be instances under present law where corporate taxpayers might take advantage of the dividends received deduction and possibly convert a pre-tax economic loss into an after tax profit. For example, a corporation may acquire stock of another corporation (in a takeover attempt or otherwise) and surrender a portion of the stock (possibly for a premium price) in a redemption transaction intended to qualify as a dividend. If the redemption does qualify as a dividend and the corporation avoids the provisions of section 1059 that would reduce the basis of the shares (perhaps by holding the stock for more than one year), then any diminution in value of the shares resulting from the redemption transaction would generate a capital loss for the shareholder. Thus, the shareholder may incur a tax on the dividend at a 6.9 percent rate (after application of the dividends received deduction) but generate a long-term capital loss (or reduce capital gain) in an amount reflecting the dividend distribution, resulting in a 28 percent tax benefit. If the dividend and the loss were equal in amount, this might produce a net 22 percent tax benefit.

This type of situation has led to suggestions that a recipient corporation be required to reduce its basis in the stock of the distributing corporation by the amount of dividends excluded from the recipient's income because of the dividends received deduction, or at least be required to reduce such basis for purposes of determining losses on ultimate sale of the stock in circumstances beyond those covered by section 1059. Nevertheless, some may contend that where more than a year has passed since the stock was acquired, there may have been substantial earnings at the corporate level that were not originally reflected in the stock basis and it may be inappropriate to link dividends paid with any losses on sale of the stock.

Treatment of tax preference items

The treatment of tax preference items, such as certain exclusions from income, credits against income tax, or tax deductions that exceed economic expense, must be examined in the context of proposals for relief from the two-tier tax on income earned by corporations. The purpose of this examination is to consider whether and to what extent preference items available to a corporation should be passed through to shareholders in conjunction with the implementation of any proposal for relief from the two-tier tax on corporate income.[41]

In general, a system of relief that passes through tax preferences not only allows the preference to reduce the corporate tax of the corporation engaging in the activity for which the incentive is granted, but also directly or indirectly allows preference items attributable to that activity to reduce the shareholder income tax liability on distributions from the corporation.

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[41] *See* William McLure, *Must Corporate Income Be Taxed Twice?* (Brookings Inst., 1979), pp. 92-143 for a comprehensive discussion of the treatment of tax preferences in the context of granting relief from the two-tier tax.

If the purpose for granting relief from the two-tier tax is to eliminate corporate level tax entirely and to treat corporate income as earned directly by shareholders, it could be argued that all preference items of a corporation should be attributed directly to its shareholders, regardless of whether they are individuals or other corporations.

On the other hand, relief from the two-tier tax may be considered simply an effort to eliminate the burden of any existing corporate level tax, at least so long as funds remain in corporate solution. Although most preference items are available both to corporations and individuals, it may be argued the effect of various preferences in the Code is largely to reduce corporate taxes. For example, even though the investment credit and ACRS are available to both corporations and individuals, these provisions benefit corporations in overwhelming proportions.[42] Under this view, it would be inappropriate to permit provisions that reduce corporate income taxes to reduce the income taxes of a corporation's individual shareholders as well. Nevertheless, it may be considered appropriate to assure that the benefit of a preference item is continued so long as the related income remains in corporate solution (even though distributed to a corporate shareholder that has made a portfolio investment and is otherwise unrelated to the distributing corporation).

Any mechanism for passing through preferences to shareholders would vary depending upon the method chosen to provide relief from the two-tier tax (i.e., shareholder credit system, dividends paid deduction, etc.) and whether the preference item takes the form of an exclusion, a credit or an accelerated deduction.[43] Similarly, any mechanism for denying the passthrough of preferences to shareholders would depend on the type of system employed.[44]

If relief from the two-tier tax is granted with respect to distributed income only (as is the case with either a dividends paid deduction or a shareholder credit system), a determination must be made

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[42] For example, the Joint Committee on Taxation estimates that the Administration proposal to repeal the investment credit will result in the collection of $117.2 billion in additional tax revenue from corporations and $22.2 billion from individuals during the period 1986-1990. (See reference in n. 38a, *supra.*)

[43] For example, if a shareholder credit system were to pass through tax credits, the proper gross-up and credit amount would equal actual corporate income taxes paid plus allowable credits. (Credits that could not be used to reduce corporate income taxes could either be passed through to the shareholders or remain with the corporation.) To pass through excludable income or accelerated deductions, distributions in excess of the corporation's taxable income would either have to be excludible by the shareholders, or the shareholders would have to be given a larger credit. If a dividends paid deduction were chosen instead, excludible income and accelerated deductions could be passed through by excluding from the shareholder's income distributions in excess of the corporation's taxable income. Credits could be passed through by excluding from shareholders' income distributions in excess of the corporation's taxable income reduced by the amount of income, the tax on which is offset by the available credits. With either a shareholder credit system or a dividends paid deduction, where the passed-through preference is an accelerated deduction, adequate provision must be made to assure that the tax deferral that such deductions are intended to provide does not result in complete exclusion.

[44] In a shareholder credit system, the passthrough of both credits and accelerated deductions or untaxed income is denied by limiting the gross-up and credit to actual taxes paid. Alternatively, if a uniform gross-up rate were desired, a compensatory tax could be imposed on a corporation to the extent that the credit available to its shareholders with respect to dividends paid exceeds the amount of corporate tax paid by the corporation. If a dividends paid deduction were used, the passthrough could be denied by limiting the deduction to the excess of taxable income over the amount that if granted to the corporation as a deduction would yield the same tax benefit as any credits used by the corporation to reduce its tax liability.

whether the distribution has been from taxed or untaxed earnings. Three different approaches are possible.

The first approach treats dividends as paid pro rata from taxed and untaxed corporate income. Thus, if a dividends paid deduction were used, for example, a corporation that has $100 of economic income but only $50 of taxable income would treat 1/2 (i.e., $50 divided by $100) of its dividends paid as eligible for the dividends paid deduction.

The second approach treats dividends as paid first out of income that has not been taxed and denies any dividends paid deduction unless distributions exceed a corporation's taxable income.

The third approach—which is the approach adopted by the Administration proposal—treats dividends as paid first out of income that has borne corporate tax. This approach might be viewed as permitting some amount of corporate tax incentives to be applied to reduce the double tax on distributions of earnings that did bear corporate tax. To this extent, it might be seen as permitting an indirect additional benefit to all shareholders from corporate level preferences. However, this approach is significantly simpler to implement than either of the others, in terms of the accounting that it would require.

Under the Administration proposal, all corporate income that was subject to tax would be added to the QDA in full even if the tax were imposed at less than the top corporate rate. This would include, for example, long-term capital gain that was taxed at preferential capital gains rates.[45]

Where a corporation with long-term capital gain also has ordinary income, it is possible that a 10 percent dividends paid deduction would offset more than 10 percent of the corporation's tax liability on the related income. Consideration may be given to reducing the amount added to the QDA with respect to net capital gain, in order to avoid granting greater benefits with respect to such corporate income.

International aspects

Foreign shareholders

A significant international tax issue raised by proposals for relief from the two-tier tax on corporate income is whether such relief should be granted with respect to shares in a U.S. corporation owned by foreign shareholders and, if so, to what extent. If either denial or limitation of the relief is desired, a related issue is the manner in which the relief may be denied or limited within the framework of present U.S. income tax treaties.

Denial of relief where there are foreign shareholders is arguably inconsistent with the goals of avoiding some of the distortions of the two-tier tax; these distortions arise irrespective of the nationality of the shareholder or the country that receives the shareholder

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[45] It would also include income taxed at marginal rates lower than the rates against which the dividends-paid deduction is taken. For example, corporate income tax may be paid in one year at a 15-percent rate, and dividends paid out of this income may give rise to a 10-percent dividends paid deduction that offsets income in the 33-percent bracket. The contrary result could also occur. If this were perceived as a problem, the benefit of a deduction arising from the distribution of income taxed at a different rate could be adjusted to reflect the amount of tax paid on such income, though this could involve significant tracing complexity.

level tax. On the other hand, the relief arguably is not intended to lessen the U.S. taxation of income earned by foreigners through U.S. corporations, particularly where under an existing income tax treaty, such foreign shareholders pay little tax on dividends received from U.S. corporations. In addition, most other countries that have adopted some form of relief from a two-tier tax generally do not extend the relief to foreign shareholders unilaterally; some countries, however, provide relief for foreign shareholders through bilateral treaties.

If relief from the two-tier tax is implemented through a dividends paid deduction, such relief can be denied where there are foreign shareholders, either by denying the deduction to the corporation for dividends paid to foreign shareholders or by imposing a compensatory withholding tax (in addition to any other withholding tax) equal to the tax benefit received by the corporation on the dividends paid to foreign shareholders.

Although disallowance of the dividends paid deduction would accomplish the goal of collecting tax on income earned in the United States, it may be considered unfair and undesirable for the value of the U.S. shareholders' shares to be affected by the fact that other shareholders are foreign. Accordingly, apart from treaty considerations discussed below, a compensatory withholding method may be preferable since the benefit of the relief is in effect "paid back" directly only by foreign shareholders rather than proportionately by all shareholders.

If an imputation system, rather than a dividends paid deduction, were used to implement the relief, the relief could be denied entirely to foreign shareholders by not permitting the gross-up and credit, or could be denied in part in some cases by not permitting a refund of any unused credit. Where the degree of relief contemplated is relatively small, however, as is true of the Administration proposal, nonrefundability may not be meaningful since in many cases the appropriate credit may be less than the pre-credit U.S. taxes payable even where such taxes are reduced pursuant to a treaty.

If relief from the two-tier tax is to be denied to foreign shareholders who are entitled to a maximum rate of tax on dividends pursuant to a treaty, the method chosen to deny relief may have a bearing on whether the denial can be viewed as a violation of the treaty in question. In particular, the imposition of a compensatory withholding tax in conjunction with a dividends paid deduction could be considered a technical violation of treaties that provide a maximum withholding rate on dividends. This is so despite the fact that the compensatory withholding tax is a substitute for the collection of additional corporate tax, which would not violate these treaties. Moreover, if a shareholder credit system were adopted and the credit were denied to foreign shareholders, the same substantive result would be reached without any arguable treaty violation.[46]

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[46] Discussion of considerations relating to the potential treaty violations arising from this proposal is contained in a separate Joint Committee pamphlet, *Tax Reform Proposals: Taxation of Foreign Income and Foreign Taxpayers* (JCS-25-85), July 18, 1985, pp. 141-147.

As discussed above, the Administration proposal would impose a compensatory withholding tax on dividends paid to foreign shareholders who are not entitled to treaty benefits but, at least initially, would not impose the additional withholding on shareholders who are entitled to treaty benefits. The proposal retains authority for the Treasury to impose the additional withholding in order to retain bargaining power in negotiating reciprocal relief for U.S. shareholders of foreign corporations where the foreign corporation's national shareholders are afforded relief from a two-tier tax. If Treasury did not impose such withholding, this approach could have the effect of permanently lowering, without compensation, the U.S. tax on income earned by corporations to the extent the corporation has shareholders in any of the many countries that offer no relief from two-tier taxation.

Foreign corporations

Under the Administration proposal, a foreign corporation is not entitled to the dividends paid deduction even with respect to dividends paid from earnings that were subject to U.S. tax. Certain treaties arguably may provide, however, that foreign persons (including corporations) are entitled to the same U.S. income tax treatment as a similarly situated U.S. person. Accordingly, consideration may be given to extending the deduction to foreign corporations entitled to such treatment under a treaty, where dividends are paid to U.S. shareholders from earnings subject to U.S. tax. Alternatively, such a foreign corporation could be given an election to be treated as a United States corporation for all income tax purposes.[47]

Source rules

The Administration proposal indicates that the dividends paid deduction should be allocated between U.S. and foreign source income in proportion to the income out of which the dividends were paid. No method is specified for determining the income from which the dividends were paid. Where dividends paid could be attributed to more than one year, the choice can have significant practical impact. For example, if, in a year that a corporation has excess foreign tax credits, it pays dividends with respect to which it is entitled to a dividends paid deduction, the availability of the corporation's foreign tax credits may be further restricted if the dividends paid are deemed to be paid out of earnings from a year in which the corporation had a relatively high percentage of foreign source income. The availability of the foreign tax credits may be enhanced, however, if the dividends are deemed to be paid out of earnings in a year in which the corporation had a relatively high percentage of domestic source income.

Therefore, consideration may be given to the provision of appropriate allocation rules in connection with the adoption of a dividends paid deduction. Possible rules include proportionate allocation to the earliest years, to the most current years, or to all accumulated earnings. Consideration should be given, however, to possi-

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[47] *Cf.* sec. 897(i).

ble manipulation of the timing of dividend payments that these rules might foster.[48] The deduction might also be allocated first to U.S. or first to foreign income. Allocating all dividends first to foreign source income might be considered harsh, while allocation first to U.S. income may be inappropriately lenient.

Treatment of foreign tax credit

As discussed above, the Administration proposal generally would not permit a dividends paid deduction at the corporate level to the extent dividends are paid out of earnings that bore no corporate tax. The proposal treats corporate income that did bear foreign tax, but that did not bear U.S. tax due to the foreign tax credit, in the same manner as income that did not bear U.S. tax for other reasons such as accelerated depreciation or other tax preference items. Thus, income that does not bear from U.S. tax due to the foreign tax credit is not added to the QDA.

There is controversy about whether the foreign tax credit should properly be treated in the same manner as a "preference" item. The credit is widely used by countries to reduce international double taxation. It is generally available only where foreign taxes are paid or accrued, thus reducing the amounts a corporation will have available for distribution. On the other hand, foreign countries that have adopted some form of relief from corporate double taxation generally do not treat foreign taxes paid by their domestic corporations as taxes paid, for purposes of a shareholder credit or comparable provision.

Some may contend that the Administration proposal does not provide equal treatment for U.S. and foreign investment by U.S. corporations, because the dividends paid deduction is allowed for distributions of income that has borne only U.S. tax, but not for income that has borne a comparable foreign tax. Others may contend that a U.S. tax benefit has been derived from the foreign tax credit, even though foreign taxes have also been paid. They may also contend that the U.S. should not unilaterally grant relief where other countries do not.

Tax-exempt shareholders

The Administration proposal contains no special rules for situations where a corporation has tax-exempt shareholders such as charitable organizations or tax-qualified pension plans.

Where relief from the two-tier tax is granted, the treatment of shareholders who are tax-exempt raises difficult issues. Denying the relief could be viewed as inappropriately diminishing the relative advantage of tax exemption over ordinary taxable status. On the other hand, granting the relief where a shareholder is a tax-exempt entity could permit business income earned by a taxable corporation and distributed to its tax-exempt shareholders to escape tax entirely, simply because the shareholders are tax-exempt.

As one example, if a taxable corporation owned entirely by a tax-exempt entity distributed all its income, and if there were a 100

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[48] *Compare* problems arising in connection with the deemed-paid foreign tax credit, discussed in a separate Joint Committee pamphlet, n. 46, *supra*, pp. 63-70.

percent dividends paid deduction, the corporation would pay no tax. This result would be inconsistent with the rules that tax unrelated business income of tax-exempt entities and generally do not permit tax-exempt entities to engage in regular business activities free of tax on the business income. Although the Administration proposes only a 10 percent (rather than 100 percent) dividends paid deduction, the issue is inherent in the proposal.

If it were considered desirable to deny the relief in the case of distributions to tax-exempt shareholders, and a dividends paid deduction were chosen as the basic method of relief, the relief could be denied by treating the deductible portion of dividends paid to tax-exempt entities as unrelated business income. This would require reporting of the same type already required by the Administration for dividends paid to corporations.

Such an approach would be similar to the compensatory withholding tax the Administration proposes for certain foreign shareholders; however, the tax would not be collected by the paying corporation as a withholding agent. A withholding tax approach could be used if desired.

Another possibility would be to deny the dividends paid deduction to a corporation that is owned entirely, or to a specified extent, by tax exempt entities. Where a corporation is owned both by taxable persons as well as tax-exempt entities, however, denial of the dividends paid deduction for dividends paid to tax-exempt shareholders would impose an additional tax burden on the taxable shareholders. If an imputation credit system were used, the credit could simply be denied (i.e., be made nonrefundable) in the case of a tax-exempt shareholder.

Transition issues

Certain issues exist relating to the one-time effects of implementing some measure of relief from the two-tier tax. One such issue is whether the relief may give a windfall to present owners of corporate equity, whose shares may become more valuable because of the lower corporate tax burden. The extent of this windfall is somewhat speculative because of uncertainty about the incidence of the corporate tax. To the extent the corporate tax is passed on to consumers or employees, for example, its elimination would not necessarily provide a windfall to shareholders, at least in the long run. Nevertheless, if the possibility of a windfall were perceived to be a problem, one solution would be a phase in of the relief. Another solution would be to extend the relief only to equity issued after the the relief provisions generally become effective, as suggested by the ALI Reporter's study.

Considerations relating to the revenue impact of any major relief also might favor distinguishing new equity from equity existing at the time such relief is granted.

Nevertheless, any approach that requires distinguishing new from old equity may raise substantial administrative difficulties, particularly with respect to situations where a corporation has undertaken various capital transactions—for example, a redemption of old stock and issuance of new stock, possibly to some of the "old" shareholders.

III. DISTRIBUTIONS AND LIQUIDATING SALES OF APPRECIATED ASSETS—THE *GENERAL UTILITIES* RULE

Present Law and Background

Overview

As a general rule, corporate earnings from sales of appreciated property are taxed twice, first to the corporation when the sale occurs, and again to the shareholders when the net proceeds are distributed as dividends. At the corporate level, the income is taxed at ordinary rates if it results from the sale of inventory or other ordinary income assets, or at capital gains rates if it results from the sale of a capital asset held for more than six months. With certain exceptions, shareholders are taxed at ordinary income rates to the extent of their pro rata share of the distributing corporation's current and accumulated earnings and profits (*see* Part II, above).

An important exception to this two-level taxation is the so-called *General Utilities* rule.[49] The *General Utilities* rule permits nonrecognition of gain by corporations on certain distributions of appreciated property[50] to their shareholders and on certain liquidating sales of property. Thus, its effect is to allow appreciation in property accruing during the period it was held by a corporation to escape tax at the corporate level. At the same time, the transferee (the shareholder or third-party purchaser) obtains a stepped-up, fair market value basis under other provisions of the Code. The "price" of a step up in the basis of property subject to the *General Utilities* rule is typically a single, capital gains tax paid by the shareholder on receipt of a liquidating distribution from the corporation.

Although the case involved a dividend distribution of appreciated property by an ongoing business, the term "*General Utilities* rule" is often used (and will be used herein) in a broader sense to refer to the nonrecognition treatment accorded in certain situations to liquidating as well as nonliquidating distributions to shareholders and to liquidating sales. The rule is codified in several elaborate and often complex provisions of the Internal Revenue Code. Section 311 governs the treatment of nonliquidating distributions of property (dividends and redemptions), while section 336 governs the treatment of liquidating distributions in kind. Section 337 provides nonrecognition treatment for certain sales of property pursuant to a plan of complete liquidation.

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[49] *General Utilities & Operating Co.* v. *Helvering*, 296 U.S. 200 (1935).

[50] Taxable gain may result on disposition of property even if the property's economic value remains constant (or decreases) over the taxpayer's holding period, due to tax depreciation and other downward adjustments to basis. The term "appreciated property" as used herein refers to property whose fair market value exceeds its adjusted (and not necessarily its original) basis in the hands of the transferor corporation.

As described in the historical discussion below, numerous limitations on the *General Utilities* rule, both statutory and judicial, have developed over the years. Some directly limit the statutory provisions embodying the rule, while others, including the collapsible corporation provisions, the recapture provisions, and the tax benefit doctrine, do so indirectly.

Case law and statutory background

Genesis of the General Utilities rule

The precise meaning of *General Utilities* has been a matter of considerable debate since the decision was rendered in 1935. The essential facts were as follows. General Utilities had purchased 50 percent of the stock of Islands Edison Co. in 1927 for $2,000. In 1928, a prospective buyer offered to buy all of General Utilities' shares in Islands Edison, which apparently had a fair market value at that time of more than $1 million. Seeking to avoid the large corporate-level tax that would be imposed if it sold the stock itself, General Utilities offered to distribute the Islands Edison stock to its shareholders with the understanding that they would then sell the stock to the buyer. The company's officers and the buyer negotiated the terms of the sale but did not sign a contract. The shareholders of General Utilities had no binding commitment upon receipt of the Islands Edison shares to sell them to the buyer on these terms.

General Utilities declared a dividend in an amount equal to the value of the Islands Edison stock, payable in shares of that stock. The corporation distributed the Islands Edison shares and, four days later, the shareholders sold the shares to the buyer on the terms previously negotiated by the company's officers.

The Internal Revenue Service took the position that the distribution of the Islands Edison shares was a taxable transaction to General Utilities. Before the Board of Tax Appeals,[51] the Commissioner's rationale was that the company had created an indebtedness to its shareholders in declaring a dividend, and that the discharge of this indebtedness using appreciated property produced taxable income to the company under the holding in *Kirby Lumber Co.* v. *United States*.[52] The Board rejected this argument, holding that where a dividend resolution imposes only the obligation to distribute in kind and it is discharged in that manner, the corporation realizes no gain or loss. It found that General Utilities had declared and paid a dividend in Islands Edison stock.

Before the Fourth Circuit,[53] the Commissioner renewed his discharge of indebtedness argument and raised a new argument. He argued that the sale of the Islands Edison stock was in reality made by General Utilities rather than by its shareholders following distribution of the stock. The court, while agreeing with the court below in rejecting the discharge of indebtedness argument, found that the shareholders were merely the agents or conduits of the true seller, General Utilities. It held that since the transaction was

[51] 29 B.T.A. 934 (1934)
[52] 284 U.S. 1 (1931).
[53] 74 F.2d 972 (4th Cir. 1935).

in substance a sale by General Utilities, gain was realized and must be recognized by the corporation.

Before the Supreme Court, the Commissioner made both of the arguments advanced in the courts below and raised a third argument. He argued that a distribution of appreciated property by a corporation in and of itself constitutes a realization event. All dividends are distributed in satisfaction of the corporation's general obligation to pay out earnings to shareholders, he contended, and the satisfaction of that obligation with appreciated property causes a realization of the gain.

The Supreme Court affirmed the holdings of both of the lower courts that the distribution did not give rise to taxable income under a discharge of indebtedness rationale. It reversed the Court of Appeals' decision on the imputed sale theory on procedural grounds, however, holding that the court should not have considered an argument not presented to the trial court. The Court did not directly address the Commissioner's third argument, that the company realized income simply by distributing appreciated property as a dividend. There is disagreement over whether the Court rejected this argument on substantive grounds or merely on the ground it was not timely made. Despite the ambiguity of the Supreme Court's decision, however, subsequent cases interpreted the decision as rejecting the Commissioner's third argument and as holding that no gain is realized on corporate distributions of appreciated property to its shareholders.

Five years after the decision in *General Utilities*, in a case in which the corporation played a substantial role in the sale of distributed property by its shareholders, the Commissioner successfully advanced the imputed sale argument the Court had rejected earlier on procedural grounds. In *Commissioner* v. *Court Holding Co.*,[54] the Court upheld the Commissioner's determination that in substance the corporation rather than the shareholders had executed the sale and, accordingly, must recognize gain.

In *United States* v. *Cumberland Public Service Co.*,[55] the Supreme Court reached a contrary result where the facts showed the shareholders had in fact negotiated a sale on their own behalf. The Court stated that Congress had imposed no tax on liquidating distributions in kind or on dissolution, and that a corporation could liquidate without subjecting itself to corporate gains tax notwithstanding a primary motive to avoid the corporate tax.[56]

In its 1954 revision of the Internal Revenue Code, Congress reviewed *General Utilities* and its progeny and decided to deal with the corporate-level consequences distributions statutorily. It essentially codified the result in *General Utilities* by enacting section 311(a), providing that no gain or loss is recognized to a corporation on a distribution of property with respect to its stock. Congress also enacted section 336, which in its original form provided for nonrecognition of gain or loss to a corporation on distributions of property in partial or complete liquidation. As discussed below, section 336 no longer applies to distributions in partial liquidation, though in

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[54] 324 U.S. 331 (1945).
[55] 338 U.S. 451 (1950).
[56] *Id.* at 454-455.

certain limited circumstances a distribution in partial liquidation may still qualify for nonrecognition at the corporate level. Finally, Congress in the 1954 Act provided that a corporation does not recognize gain or loss on a sale of property if it adopts a plan of complete liquidation and distributes all of its assets to its shareholders within 12 months of the date of adoption of the plan (sec. 337). Thus, the distinction drawn in *Court Holding Co.* and *Cumberland Public Service Co.*, between a sale of assets followed by a liquidating distribution of the proceeds and a liquidating distribution in kind followed by a shareholder sale, was in large part eliminated.

Regulations subsequently issued under section 311 acknowledged that a distribution in redemption of stock constituted a "distribution with respect to ... stock" within the meaning of the statute.[57] The 1954 Code in its original form, therefore, generally exempted all forms of nonliquidating as well as liquidating distributions to shareholders from the corporate-level tax.

Nonliquidating distributions: section 311

Three exceptions to the rule that gain was not recognized on nonliquidating distributions were provided under section 311. The purpose of these exceptions was to eliminate what were perceived to be opportunities for tax avoidance presented by the general rule. First, nonrecognition was not available for distributions of installment obligations to shareholders. Under the predecessor of section 453B, a corporation recognized gain to the extent of the excess of the face value of the obligation over the corporation's adjusted basis in the obligation.[58] Second, upon distribution of LIFO inventory,[59] a corporation recognized gain to the extent the basis of inventory determined under a FIFO method exceeded its LIFO value.[60] Third, a corporation recognized gain on the distribution of encumbered property to the extent the liabilities exceeded the basis of the property in the distributing corporation's hands.[61] These three statutory exceptions to section 311 have remained essentially unchanged since their enactment.

1969 amendments.—On three separate occasions since the enactment of section 311, Congress has reacted to perceived abuse of the provision by further restricting its scope. In 1969, Congress became aware of instances of large corporations making tender offers for their own stock and using appreciated portfolio stock to effectuate the redemption. These transactions were viewed as having the same economic effect as if the distributing corporations had sold the portfolio stock and redeemed their own stock with the proceeds. Congress "[did] not believe that a corporation should be permitted

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[57] Treas. Reg. sec. 1.311-1(a).

[58] Under both the original statute and present law, installment obligations received by a corporation in a sale or exchange qualifying for nonrecognition under section 337 may be distributed to shareholders without recognition at the corporate level. Sec. 453B(d)(2).

[59] Under the last-in, first-out or "LIFO" method of accounting, goods purchased or produced most recently are deemed to be the first goods sold. During periods of rising costs, LIFO inventory accounting tends to increase cost of goods sold and reduce gross income from sales.

[60] Sec. 311(b). "FIFO" (first-in, first-out) accounting assumes that the first goods purchased or produced are the first goods sold.

[61] Sec. 311(c). This rule would prevent, for example, a corporation's borrowing against appreciated corporate assets and immediately transferring the mortgaged assets to its shareholders—thus achieving the same economic position as if it had sold assets.

to avoid tax on any appreciated property (investments, inventory, or business property) by disposing of property in this manner."[62]

Congress addressed this problem by amending section 311 to require recognition of gain by a corporation on distributions in redemption of its stock. (For purposes of section 311, a redemption included a distribution in exchange for stock that was treated as a dividend subject to section 301, e.g., because it was "essentially equivalent to a dividend.") Certain types of redemptions were excepted, including distributions in complete termination of a 10 percent shareholder's interest, certain distributions of the stock or obligations of a 50 percent-or-more subsidiary, distributions to pay death taxes, distributions to private foundations, distributions by regulated investment companies upon the demand of a shareholder, distributions pursuant to certain antitrust decrees, and distributions constituting divestitures by bank holding companies.

TEFRA amendments.—In 1982, Congress, again responding to highly publicized tax avoidance transactions involving distributions of appreciated assets, further narrowed the applicability of the *General Utilities* rule. The transactions involved arrangements between a corporation and a prospective purchaser of a subsidiary of the corporation whereby the purchaser made a tender offer for shares of the parent's stock equal in value to the subsidiary's stock. The parent would then, pursuant to a prearranged plan, redeem the stock held by the purchaser using the stock of the subsidiary.

Although it was unclear whether these transactions qualified for nonrecognition treatment under then-existing law,[63] Congress believed it was desirable to clarify that they did not. Moreover, it determined that whether or not the stock ownership was transitory, as in the publicized cases, a distribution of property in a stock redemption was economically equivalent to a direct sale of the distributed property and should generally be treated as such for tax purposes. Congress felt that as a general rule, property should not be allowed to leave corporate solution in a redemption and take a stepped-up basis in the hands of a transferee without a corporate level tax being paid on the appreciation.

Under amendments made in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), the general rule in the case of distributions to *corporate* shareholders in redemption of their stock was that the distributing corporation recognized gain. Thus, for example, the exceptions to recognition for distributions in complete redemption of the stock of 10 percent shareholders and for distributions of stock or obligations of a 50 percent subsidiary were repealed in the case of corporate distributees. In a liberalization of prior law, however, nonrecognition treatment was accorded to redemption distributions to corporate shareholders constituting a dividend. In such a case, the distributed property would generally take

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[62] S. Rep. No. 552, 91st Cong., 1st Sess. 279 (1969).

[63] Section 311(a) applies only if a distribution is to a shareholder in its capacity as a shareholder, and not in some other capacity such as vendee. Rev. Rul. 83-38, 1983-1 C.B. 76. *See also* Rev. Rul. 80-221, 1980-2 C.B. 170 (transaction that was in form a redemption of stock with corporate property treated as direct sale of assets to distributee where stock ownership was transitory).

a carryover rather than a fair market value basis in the hands of the distributee.[64]

Distributions in redemption of the stock of *noncorporate* shareholders (including S corporations) generally resulted in recognition of gain to the distributing corporation under the TEFRA amendments unless the distribution was to certain substantial, long-term shareholders and consisted of stock or obligations of a subsidiary.[65] As discussed below, an exception was also provided for certain redemptions of stock held by noncorporate shareholders constituting partial liquidations.

The TEFRA amendments did not disturb the exceptions for distributions to pay death taxes, to private foundations, and regulated investment companies.

1984 amendments.—The applicability of the *General Utilities* rule to nonliquidating distributions was eroded still further by amendments in the Deficit Reduction Act of 1984.[66] Prior to the 1984 Act, the gain recognition rule of section 311(d)(1) applied only to distributions of property in redemption of a shareholder's stock. The 1984 Act extended the gain recognition rule to most dividend distributions of appreciated property, including carryover basis distributions to corporate shareholders (whether or not in redemption of stock). In general, dividend distributions to noncorporate shareholders are also subject to the gain recognition rule. However, the 1984 Act preserved nonrecognition at the corporate level for distributions of "qualified dividends," defined as dividends to noncorporate shareholders of property (other than inventory or receivables) used in the active conduct of certain "qualified businesses."[67] The Act also retained nonrecognition treatment for certain redemption distributions with respect to qualified stock held by noncorporate shareholders. Unlike prior law, the 1984 Act required the application of the LIFO recapture and installment obligation rules before the application of the recognition rules of section 311(d)(1).

Liquidating distributions and sales: sections 336 and 337

The rules regarding nonrecognition of gain on distributions in liquidation of a corporation are more liberal than those applicable to nonliquidating distributions. Section 336 as enacted in 1954 Code provided for nonrecognition of gain or loss by a corporation on the distribution of property in complete or partial liquidation of the corporation. An exception was provided (that is, gain was recognized) for a distribution of an installment obligation acquired other than in a liquidating sale that would be tax-free under section 337.[68]

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[64] Sec. 301(d)(2). The distributee's basis would be the fair market value of the property if that were lower than the distributor's basis.

[65] More specifically, the distribution had to be with respect to "qualified stock," more than 50 percent in value of the subsidiary's stock had to be distributed, and certain active business requirements had to be satisfied. "Qualified stock" was defined as stock held by noncorporate shareholders owning 10 percent or more in value of the distributing corporation's outstanding stock for at least five years (or the period the corporation had been in existence, if shorter).

[66] Pub. L. 98-369, sec. 54.

[67] Sec. 311(a)(3). A "qualified business" is any trade or business that has been actively conducted for five years and was not acquired in a transaction in which gain or loss was recognized during such period. Sec. 311(e)(2)(B)(i).

[68] Sec. 453(d), the predecessor of sec. 453B(d). Section 453(d) also provided (and sec. 453B(d) now provides) that no gain or loss is recognized by a corporation on distribution of an install-

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Section 336, unlike section 311, has survived with relatively few modifications since its enactment. TEFRA amended this provision to make it inapplicable to partial liquidations, but granted nonrecognition treatment elsewhere in the Code for certain partially liquidating distributions made with respect to qualified stock. Qualified stock is defined in the same manner as for nonliquidating distributions. Nonrecognition is therefore limited to distributions to long-term, 10 percent shareholders other than corporations.[69] TEFRA also required recognition of the LIFO recapture amount in liquidating distributions.

Section 337 has likewise remained essentially in its original form. It provides that if a corporation adopts a plan of complete liquidation and within 12 months distributes all of its assets in complete liquidation, gain or loss on any sales by the corporation during that period is generally not recognized.[70] Section 337 does not apply, and recognition is required, on sales of inventory (other than inventory sold in bulk), stock in trade, or property held primarily for sale to customers in the ordinary course of business. If the corporation accounts for inventory on a LIFO basis, section 337 requires that the LIFO recapture amount be included in income.

Special rules for distributions by S corporations

The Code allows a closely-held business operating in corporate form to elect to have business gains and losses taxed directly to or deducted directly by its individual shareholders. This election is available under subchapter S of the Code (secs. 1361–1379). The principal advantage of a subchapter S election to the owners of a business is the ability to retain the advantages of operating in corporate form while avoiding double taxation of corporate earnings.

Prior to 1983, shareholders of corporations making a subchapter S election were taxed on actual cash dividend distributions of current earnings and profits of the corporation, and on undistributed taxable income as a deemed dividend. Accordingly, all of the taxable income of a corporation taxable under subchapter S generally passed through to its shareholders as dividends. A shareholder increased his basis in his stock by the amount of his pro rata share of undistributed taxable income.

The Subchapter S Revision Act of 1982 substantially modified these rules. The dividends-earnings and profits system was abandoned in favor of a pass-through approach based more closely on the system under which partnership income is taxed. Under these new rules, gain must be recognized by an S corporation (which gain is passed through to its shareholders) on a nonliquidating distribution of appreciated property as if it had sold the property for its fair market value (sec. 1363(d)). The purpose of this rule is to

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ment obligation if the obligation is distributed in a section 332 liquidation of a controlled subsidiary into its parent and the parent takes a carryover basis under section 334(b)(1).

[69] *See* secs. 311(d)(2)(A), 302(b)(4), (e). TEFRA added a provision that grants regulatory authority to prevent circumvention of the repeal of special tax treatment for partial liquidations through the use of section 355, 351, or 337, or other provisions of the Code or the regulations. Sec. 346(b).

[70] As previously noted, the original motivation for the relief was apparently to avoid the necessity of making the often difficut factual determination of who (the shareholders or the corporation) actually effectuated the sale, and to avoid the perceived unfairness of having tax consequences turn on such formalistic distinctions.

assure that the appreciation does not escape tax entirely. A shareholder in an S corporation generally does not recognize gain on receipt of property from the corporation, but simply reduces his basis in his stock by the fair market value of the property, taking a basis in the property equal to that value. The shareholder can then sell the property without recognizing any gain. Thus, unless the distribution triggered gain at the corporate level, no current tax would be paid on the appreciation in the distributed property.

Liquidating distributions by an S corporation are taxed in the same manner as liquidating distributions of C corporations. Thus, no gain is recognized by the corporation (sec. 1363(e)). Although the *General Utilities* rule in this context is not responsible for the imposition of only a single, shareholder-level tax on appreciation in corporate property,[71] it may allow a portion of the gain that would otherwise be ordinary to receive capital gains treatment.

Statutory law and judicial doctrines affecting application of General Utilities rule

Recapture rules

The nonrecognition provisions of sections 311, 336, and 337 are subject to several additional limitations beyond those expressly set forth in those sections. These limitations include the statutory "recapture" rules for depreciation deductions, investment tax credits, and certain other items that may have produced a tax benefit for the transferor-taxpayer in prior years.[72]

The depreciation recapture rules (sec. 1245) were enacted as part of the Revenue Act of 1962. They require inclusion, as ordinary income, of any gain attributable to depreciation deductions previously claimed by the taxpayer with respect to "section 1245 property"—essentially, depreciable personal property—disposed of during the year,[73] to the extent the depreciation claimed exceeds the property's actual decline in value. The 1962 Act also added a provision requiring recapture of amounts claimed as investment credits on premature dispositions of property for which a credit was claimed (sec. 47).

Congress has applied a more limited depreciation recapture rule to certain real estate. Under section 1250, gain on disposition of residential real property held for more than one year is recaptured as ordinary income to the extent prior depreciation deductions exceed depreciation computed on the straight-line method (sec. 1250). Gain on disposition of nonresidential real property held for more than one year, however, is generally subject to recapture of all depreciation unless a straight line method has been elected, in which case there is no recapture.[74]

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[71] A shareholder would under the subchapter S rules be entitled to a basis increase equal to the amount of gain recognized by the corporation.

[72] These rules apply not just to corporate distributions but to sales and other dispositions of property, other than in tax-free reorganizations.

[73] In the case of sales or exchanges of property in taxable transactions, the recapture rules convert a portion of what would otherwise be capital gain into ordinary income. In the case of nonrecognition transactions, the recapture rules require recognition of gain that would otherwise go unrecognized.

[74] Sec. 1245(a)(5).

A number of other statutory recapture provisions may apply to a liquidating or nonliquidating distribution of property, including section 617(d) (providing for recapture of post-1965 mining exploration expenditures), section 1252 (soil and water conservation and land-clearing expenditures), and section 1254 (post-1975 intangible drilling and development costs).

Collapsible corporation rules

Section 341 modifies the tax treatment of transactions involving stock in or property held by "collapsible" corporations. In general, a collapsible corporation is one the purpose of which is to convert ordinary income into capital gain through the sale of stock by its shareholders, or through liquidation of the corporation, before substantial income has been realized.

One of the principal abuses the collapsible corporation rules were intended to address was the acquisition or production by a corporation of assets that rapidly increased in value, primarily through the efforts of the corporation, followed by a liquidating distribution of those assets to shareholders before the corporation had recognized any significant amount of taxable income from the assets. The shareholders would take a stepped-up, fair market value basis in the distributed property at the price of a single, shareholder-level capital gains tax.

Alternatively, the shareholders could sell their stock to a third party, who would take a stepped-up basis in the property,[75] or the corporation could sell the property pursuant to a section 337 plan of liquidation. In either case, only a single capital gains tax at the shareholder level would have been paid on the appreciation in the property.

Under section 341, if a shareholder disposes of stock in a collapsible corporation in a transaction that would ordinarily produce long-term capital gain, the gain is treated as ordinary income. Likewise, any gain realized by a shareholder on a distribution of appreciated property from a collapsible corporation will be ordinary income. Finally, section 337 is inapplicable in the case of a collapsible corporation. Thus, sales of appreciated inventory or other property held by the corporation for sale to customers generate ordinary income which is fully recognized at the corporate level.[76]

Certain stock purchases treated as asset purchases

Section 338 of the Code, added by TEFRA, permits a corporation that purchases a controlling stock interest in another corporation (the "target" corporation) to elect to treat the transaction as a purchase of the assets of that corporation for tax purposes. If the election is made, the target is treated as if it had sold all of its assets pursuant to a plan of complete liquidation under 337 on the date of

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[75] This step-up could be achieved in a liquidation of the acquired corporation under sections 332 and 334(b)(2) prior to TEFRA, or through a section 338 election after TEFRA. Section 338 is discussed further below.

[76] Gain on sales of capital or section 1231 assets in a section 337 liquidation of a collapsible corporation may be taxed at capital gains rates. A sale in liquidation may produce corporate level income that eliminates the collapsible status of the corporation, so that the shareholders will receive capital gains treatment on relinquishment of their shares in the liquidation.

the stock purchase, for an amount equal to the purchase price of its stock plus its liabilities. Accordingly, no gain is recognized on the deemed sale other than gain attributable to section 1245 or other provisions that override section 337. The target is then treated as a newly organized corporation that purchased all of the "old" target's assets for a price equal to the purchase price of the stock plus the old target's liabilities on the day after the stock purchase. Thus, the new target corporation may obtain a stepped-up basis in its assets equal to their fair market value.

Prior to the enactment of section 338, this same result could be achieved under sections 332 and 334(b)(2) by liquidating the acquired corporation into its parent within a specified period of time. One abuse Congress sought to prevent in enacting section 338 was selective tax treatment of corporate acquisitions. Taxpayers were able to take a stepped-up basis in some assets held by a target corporation or its affiliates while avoiding recapture tax and other unfavorable tax consequences with respect to other assets.[77] Section 338 contains elaborate "consistency" rules designed to prevent selectivity with respect to acquisitions of stock and assets of a target corporation and members of its affiliated group by an acquiring corporation and its affiliates. All such purchases by the acquiring group must be treated consistently as either asset purchases or stock purchases if they occur within the period beginning one year before and ending one year after the acquisition of the target corporation's stock.[78]

Sections 446 and 482

Under present law, it is unclear to what extent the clear reflection of income requirement of section 446(b) may override the *General Utilities* rule. In one case, it was held that the Commissioner could, pursuant to his authority under section 446(b), require construction companies which used the completed contract method of accounting and which liquidated before the contracts were completed to switch to the percentage of completion in the year of the liquidation, hence recognizing income.[79]

Similarly, it is unclear whether the Commissioner's authority under section 482 to reallocate income and deductions among commonly controlled organizations can be exercised to require recognition of gain on liquidating distributions to a parent corporation. For example, in *General Electric Co.* v. *United States*,[80] the court ruled that a loss sustained by a parent corporation on a sale of property distributed to it in a complete liquidation of a subsidiary under section 332 could be reallocated under section 482 to the subsidiary. Other cases, however, have held to the contrary.[81]

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[77] Prior to TEFRA, a step-up could be achieved through a partial liquidation of the target as well as a complete liquidation under sections 332 and 334(b)(2).

[78] Exceptions are provided for assets acquired in the ordinary course of business, acquisitions in which the basis of property is carried over, and other asset acquisitions as provided in regulations.

[79] *Standard Paving Co.* v. *Commissioner*, 190 F.2d. 330 (10th Cir.), *cert. denied*, 342 U.S. 860 (1951).

[80] 83-2 U.S.T.C. para. 9532 (Cl.Ct. 1983).

[81] *Compare* Rev. Rul. 77-83, 1977-1 C.B. 139 (sec. 482 may override sec. 311) *with Bank of America* v. *United States*, 79-1 U.S.T.C. para. 9170 (N.D. Col. 1978) (holding to the contrary).

Liquidation-reincorporation transactions

The *General Utilities* rule is responsible at least in part for the use of a tax avoidance device known as liquidation-reincorporation. This device can take one of several forms, including (1) a complete liquidation of a corporation, followed by a transfer of all or a part of the operating assets to a new corporation organized by the shareholders, (2) a drop-down of all or part of the assets to a newly created subsidiary followed by a liquidation of the transferor corporation, or (3) a sale of all or part of the assets to a sister corporation followed by a liquidation of the selling corporation. The objectives of a liquidation-reincorporation transaction include bailing out the corporation's accumulated earnings and profits at capital gains rates and obtaining a stepped-up basis in the corporation's operating assets (again, at the price of only a single, shareholder-level capital gains tax by virtue of section 336 or 337), while continuing the business in corporate form.

The Internal Revenue Service has been successful in attacking some liquidation-reincorporation transactions by treating them as reorganizations, with any assets transferred to the new corporation taking a carryover basis. Assets retained by the shareholders are treated as "boot," generally taxable as a dividend if there is shareholder gain.[82] Amendments to section 368 made by the Tax Reform Act of 1984 liberalized the control requirement of section 368(c), thus making it easier for a liquidation-reincorporation to qualify as a nondivisive "D" reorganization.

The Internal Revenue Service and the courts have also applied the step-transaction and substance-over-form doctrines to liquidation-reincorporations.[83] Nonetheless, under some circumstances it may still be possible to achieve the tax benefits associated with a liquidation-reincorporation transaction.

Other judicially created doctrines

The courts have applied other nonstatutory doctrines from other areas of the tax law to in-kind distributions to shareholders. For example, it has been held that where the cost of property distributed in a liquidation or sold pursuant to a section 337 plan of liquidation has previously been deducted by the corporation, the tax benefit doctrine overrides the statutory rules to cause recognition of income.[84] The application of the tax benefit doctrine is, however, somewhat uncertain, turning on whether there is a "fundamental inconsistency" between the prior deduction and some subsequent event.[85]

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[82] *See, e.g., James Armour, Inc.* v. *Commissioner*, 43 T.C. 295 (1965) (sale of all operating assets of one corporation to a sister corporation owned by same shareholders in same proportions; *held*, transaction was in substance "D" reorganization combined with a boot dividend under sec. 356(a)(2)).

[83] *See, e.g.*, Rev. Rul. 61-156, 1961-2 C.B. 62; *Telephone Answering Service, Inc.* v. *Commissioner*, 63 T.C. 423 (1974), *aff'd* in unpublished opin. (4th Cir., November 8, 1976) *cert. denied*, 431 U.S. 914 (1977).

[84] *See, e.g., Bliss Dairy* v. *United States*, 460 U.S. 370 (1983) and *Tennessee Carolina Transportation, Inc.* v. *Commissioner*, 65 T.C. 440 (1975), *aff'd* 582 F.2d 378 (6th Cir. 1978) (liquidating distribution of previously expensed items); *Estate of Munter* v. *Commissioner*, 63 T.C. 663 (1975) (sale of previously deducted items pursuant to plan of liquidation).

[85] *Bliss Dairy, supra.*

The courts have also applied the assignment of income doctrine to require a corporation to recognize income on liquidating and nonliquidating distributions of its property.[86]

Administration Proposal

Neither the Administration's proposal nor the 1984 Treasury Report makes specific recommendations relating to the *General Utilities* rule. However, the Treasury Department in its 1984 Report expressed support for current efforts to simplify and rationalize the tax laws relating to the taxation of corporations and shareholders, including those relating to corporate liquidations.[87] The Administration's proposal to treat depreciable business assets ("sec. 1231 property") as ordinary income assets suggests that consideration be given to making the recapture rules for real property parallel to those applicable to personal property.

Other Proposals

S. 409 and H.R. 800 (Bradley-Gephardt)

Under the Bradley-Gephardt bill (sec. 416), gain would be recognized to a corporation on nonliquidating distributions of property (other than debt of the corporation) with respect to its stock. Gain would be recognized to a corporation on liquidating distributions of property, except where its basis in the property carries over to the distributee under section 334. Section 337 would be repealed. These amendments would be effective for transactions after 1986.

The collapsible corporation rules would be repealed for taxable years beginning after 1986 (sec. 241).

H.R. 2222 and S. 1006 (Kemp-Kasten)

The Kemp-Kasten bill (sec. 412) would likewise require recognition of gain to the corporation on liquidating and nonliquidating distributions of property, with the same exceptions provided under the Bradley-Gephardt bill. Section 337 would also be repealed. These amendments would be effective for transactions after 1985.

H.R. 1377 and S. 556 (Stark-Chafee)

Under the Stark bill, 20 percent of the gain would be recognized to the distributing or selling corporation on distributions or sales of property in liquidation. The Chafee bill would require recognition of 15 percent of such gain. These amendments would be effective for distributions or sales after 1985 and before 1990.[88]

"Hostile" takeover situations

Several bills have been introduced that would limit the applicability of the *General Utilities* rule in a narrow set of circumstances.

H.R. 1003 and S. 420 (Jones-Boren).—H.R. 1003 and S. 420 would deem an acquiring company to have made a section 338 election if

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[86] *E.g., Commissioner* v. *First State Bank*, 168 F.2d 1004 (5th Cir.), *cert. denied*, 335 U.S. 867 (1948) (a decision rendered prior to the enactment of sec. 311); *Siegel* v. *United States*, 464 U.S. 891 (1972), *cert. dism'd*, 410 U.S. 918 (1973).

[87] 1984 Treasury Report, Vol. II, p. 144.

[88] Secs. 1602, 1612.

it acquires 80 percent or more of the stock of another corporation in a "hostile" takeover. Moreover, unlike under present law section 338, section 337 would not apply to the deemed sale of the target's assets and all gain would be recognized.

S. 632 (Chafee).—S. 632 would also make the section 338 election mandatory and deny section 337 relief in hostile takeover situations. In addition, S. 632 would not permit the acquiring corporation to treat as part of its purchase price (or as part of the basis of the assets deemed to have been acquired) the tax liability of the acquired corporation attributable to the deemed sale.

Senate Finance Committee staff proposal

The staff of the Senate Finance Committee recently published its final report to the Committee on the reform of the provisions relating to the taxation of corporations and shareholders.[89] Among its recommendations is the repeal of the *General Utilities* rule. Thus, under the staff's proposal, a corporation would be required to recognize gain on essentially all nonliquidating distributions and liquidating sales and distributions of its assets. Gain would be recognized to the extent the sales price or fair market value of the assets exceeded their basis. Losses would be recognized on liquidating distributions or sales. Exceptions to these recognition rules would be provided for distributions in which the distributee's basis is a carryover basis under section 334(b) and for certain distributions of stock in a five-year subsidiary.[90]

The collapsible corporation rules (sec. 341) would be repealed under the Finance Committee staff's proposal.

Analysis

Overview

The theoretical and policy underpinnings of the *General Utilities* rule have been intensely debated since the Supreme Court rendered its somewhat ambiguous decision in 1935. The codification of the rule did little to silence this debate. As noted in the previous section, since codifying the rule in 1954 Congress has been forced to reexamine it on several occasions because of perceived abuses, and the applicability of the rule has been gradually eroded. What is left

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[89] Staff of Senate Comm. on Finance, 99th Cong., 1st Sess., *The Subchapter C Revision Act of 1985* (S. Prt. 99-47), May 1985.

[90] The Senate Finance Committee staff proposal to repeal the *General Utilities* rule is integrally related to another Senate Finance Committee staff proposal directed at the tax consequences of one corporation's acquisition of a substantial portion of the stock or assets of another corporation. This staff proposal would make the corporate level tax consequences of such an acquisition elective, and would make these consequences independent of the consequences at the shareholder level. Under the staff's proposal, an acquiring corporation could elect to treat a qualified acquisition of stock as a purchase of assets (in which case the target would recognize gain and take a new cost basis in its assets), even though the transaction constitutes a nonrecognition transaction for the target's shareholders because they receive stock in the acquiring corporation. Under present law, a cost basis is not generally obtainable without recognition of gain at the shareholder level (even though such gain may be capital gain) because the section 338 election cannot be made if the transaction constitutes a tax-free reorganization. In order to assure continuation of this symmetry — that a stepped-up basis cannot be achieved without a tax being collected at some level — while permitting separation of corporation and shareholder level consequences (a principal aspect of the proposal), the repeal of the *General Utilities* rule would be essential. A special rule would allow nonrecognition by the transferor corporation (and require a carryover basis) with respect to goodwill and other unamortizable intangibles. As noted above, the staff's proposal would repeal *General Utilities* in the context of liquidations as well as acquisitions, with certain exceptions.

is essentially a rule that permits a corporation to make liquidating distributions and liquidating sales of appreciated property (and narrowly circumscribed types of dividend distributions) without recognizing gain other than recapture amounts.

There has developed a relatively broad consensus, though by no means unanimity, among tax scholars and practitioners that the *General Utilities* rule even in its more limited form may produce arbitrary results, distort business behavior, and inject an inordinate amount of complexity (and, with it, controversy) into the tax system. While conceding some of these deficiencies, opponents of repeal argue that a rigid application of the two-tier tax to liquidating distributions is unwise and inappropriate, particularly in situations where the gain is attributable to long-held business assets and where small businesses, which may have less flexibility to avoid liquidations, are involved.

The principal arguments for and against the repeal of the *General Utilities* rule are discussed in greater detail below.

Arguments for repeal of General Utilities rule

Elimination of incentives for churning of assets and corporate takeovers

Proponents of repeal argue that the *General Utilities* rule creates artificial incentives for transfers of depreciable assets. An acquiring corporation is able to obtain a basis in assets equal to their fair market value without the transferor recognizing gain, except possibly recapture amounts. The tax deductions available under the Accelerated Cost Recovery System may make the assets more valuable in the hands of the transferee than in the hands of the present owner, even taking into account recapture taxes. Thus, the *General Utilities* rule may be responsible in part for the increase in corporate mergers and acquisitions.[91]

Elimination of bias in favor of liquidating distributions

Critics of the *General Utilities* rule also point out that it may encourage liquidations. By granting liquidating distributions more favorable treatment than distributions by ongoing corporations, it creates a bias in favor of corporate liquidations. These critics argue that economically, a liquidating distribution is indistinguishable from a nonliquidating distribution, and the two should not be treated differently for tax purposes.

Preservation of integrity of the corporate tax

Proponents of repeal of the *General Utilities* rule argue that the rule undermines the integrity of the corporate income tax by allowing assets to take a stepped-up basis without the imposition of a corporate-level tax. The *General Utilities* rule, they note, is a complete exception to general tax principles. Other nonrecognition provisions of the Code generally require a carryover basis in trans-

[91] Additional discussion of the *General Utilities* rule in the context of mergers and acquisitions appears in Joint Committee on Taxation pamphlets *Federal Income Tax Aspects of Mergers and Acquisitions* (JCS-6-85) March 29, 1985, and *Federal Income Tax Aspects of Hostile Takeovers and Other Corporate Mergers and Acquisitions (and S. 420, S. 476 and S. 632)* (JCS-9-85) April 19, 1985.

ferred assets as the price of nonrecognition, thus assuring that a tax will eventually be collected on the appreciation. The *General Utilities* rule grants a complete exemption from the tax on this gain at the corporate level by permitting a basis step-up at the price of, at most, a single, shareholder-level capital gains tax. Moreover, in some cases, this capital gains tax is not even collected immediately because the shareholder's gain is reported under the installment method. Yet the purchaser is entitled to an immediate step up to the full purchase price.

Reduction of complexity and uncertainty of tax consequences

Proponents of repeal contend that repealing sections 311, 336, and 337 would significantly simplify the corporate tax provisions of the Code. These provisions have evolved into an elaborate statutory framework with numerous definitions, limitations, and exceptions. Repeal of the *General Utilities* rule would also promote simplification by making the complex collapsible corporation rules unnecessary. Since all corporations would be taxed on distributions or liquidating sales of appreciated property, the ability of taxpayers to achieve the "bailout" that section 341 is intended to prevent would largely be eliminated.[92]

Finally, critics of the rule argue that repeal would eliminate a large and confusing body of case law and rulings that have attached to these provisions, and improve certainty of tax consequences. For example, at least in this context, the Internal Revenue Service would not have to invoke the liquidation-reincorporation, tax benefit, assignment of income, or clear reflection of income doctrines, or section 482, in an effort to prevent perceived abuses resulting from distributions of appreciated property.

Arguments against repeal

The General Utilities rule provides relief from double taxation of corporate income

Defenders of the *General Utilities* rule argue that it acts as a relief measure against double taxation of corporate gains when extraordinary events occur in the life of a corporation. They note that the Federal income tax system has never been a pure two-tier system of taxation, but rather a partially integrated one. Only a single-level tax has historically been imposed on sales or distributions of corporate assets in a liquidation. Furthermore, as a practical matter, there are numerous exceptions to the two-tier tax even outside a liquidation context. Some businesses may avoid having earnings taxed at two levels through various tax-planning techniques, such as paying out earnings as "salaries" to shareholder-employees rather than as dividends. In any event, opponents of repeal contend, the corporate tax was principally designed to reach corporate operating profits. The gains that would be taxed by repealing *General Utilities* would largely be inflationary or investment gains. Taxing income from investment more heavily would

[92] Even if the original shareholders sold their stock at capital gains rates, the corporate level tax on the gain would be preserved and would be imposed when the corporation sold the property in the course of its business or liquidated.

inhibit capital formation, lock in investments, and generally have adverse effects on the economy.

Disproportionate impact on small businesses

Opponents of repeal argue that the burden of repeal would fall primarily on small, family-owned businesses. Large, publicly held companies might seldom bear the double tax because such companies may rarely liquidate entirely. Rather, they more typically may merge into other large companies in tax-free reorganizations. Small businesses, on the other hand, have less flexibility to avoid the two-level tax through a merger. Yet such businesses present a more sympathetic case than the large public corporation, they argue. Frequently the small business will hold assets such as land, acquired from its original shareholders or their descendants, that have appreciated over a long period of time. Often these same shareholders will hold the corporation's stock at the time of the proposed liquidation. Thus, repeal of *General Utilities* would mean these small businesses will pay a double tax on the (largely inflationary) gain on their property. Alternatively, closely-held companies will be pressured to merge into larger companies rather than liquidate.

Opponents of repeal also argue that in the future, the effect of repeal would be to create a strong disincentive for incorporations of small businessess, when the corporate form may otherwise be the most appropriate method of carrying on business.

Repeal of the General Utilities rule would not reduce complexity

In response to claims that repeal would simplify the Code, opponents of repeal argue that exceptions to the recognition requirement would very likely be enacted and new complexities would inevitably result.

Additional discussion, issues, and possible proposals

The debate over the *General Utilities* rule has been related to the controversy over whether the corporate and individual income taxes should be integrated.[93] The Federal income tax system is at least nominally a double tax system. Congress first imposed the corporate tax in 1909 and has taxed corporate income separately ever since; the individual tax was first imposed in 1913.[94] Although Congress has ameliorated the impact of the double tax in indirect ways, for example, by various deductions and credits that reduce the effective corporate rate below the nominal rate, a two-tier tax system generally remains intact.

The *General Utilities* rule is sometimes defended as a de facto system of partial integration that Congress has adopted to temper the otherwise harsh consequences of the double tax. There are several responses to this argument. First, if the rule constitutes a

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[93] For a discussion of some proposals with respect to partial integration, see Part II, *supra*.

[94] The corporate tax initially was 1 percent of net income in excess of $5,000. Since there was no tax on individual income at that time, the double tax phenomenon did not exist. Even when the individual tax was enacted in 1913, it imposed a tax of only 1 percent on net incomes of individuals above $3,000 ($4,000 for married persons). A surtax of 1 percent was imposed on incomes above $20,000, rising to a rate of 6 percent for incomes above $500,000.

"system," it is an arbitrary and irrational one to the extent it accords different tax treatment to economically similar transactions such as liquidating and nonliquidating distributions. Second, there is little evidence that the codification of the *General Utilities* rule was a deliberate effort to mitigate the impact of the double tax. On the contrary, it appears Congress believed it was merely codifying prior law, and may have done so without a full understanding of the issues.[95] Finally, assuming Congress believes a system of partial or complete integration is desirable as a matter of tax or economic policy, a more direct approach may be more equitable and efficient. The dividends paid deduction proposed by the Administration[96] would be one direct method of establishing a system of partial integration.

If the two-tier tax system is to be retained, many have questioned preserving the *General Utilities* rule. The rule permits complete avoidance of the corporate level tax on liquidating distributions and permits a step-up in basis to the transferee at the price of a single, shareholder-level capital gains tax. The tax collected at the shareholder level in many instances will bear no relationship to the tax that would have been collected at the corporate level, since the amount of gain and tax rates at the two levels may differ significantly. Furthermore, the rule in conjunction with other provisions of the tax law may result not only in avoidance of tax at the corporate level, but in complete avoidance of tax. This may occur, for example, where a distribution of property or liquidation proceeds is to a shareholder who received his stock from a decedent, and hence has a fair market value basis in the stock under section 1014. Alternatively, the shareholder may be a tax-exempt entity or a foreign person not subject to U.S. tax.

Even in its present, more limited form, the *General Utilities* rule has presented opportunities for taxpayer planning to avoid recognition of gains while recognizing losses at the corporate level. For example, taxpayers have been successful in selling their depreciated assets outside of section 337, thereby recognizing the losses, while selling appreciated assets under the protection of section 337.[97]

Finally, it is difficult to avoid the conclusion that the *General Utilities* rule may tend to influence business behavior. As previously illustrated, present law provides significant incentives for acquisitions or liquidations of corporations whose assets have substantially appreciated, since a sale of the assets in the ordinary course of business would trigger tax at the corporate level. Churning of corporate assets is encouraged by the fact that an acquiring corporation can obtain a fair market value basis in the appreciated assets of another corporation without the latter recognizing gain to the extent of the appreciation. Although the selling corporation's shareholders will recognize gain on the liquidation, the gain may

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[95] The minority party report to the 1954 Code states observes that "[d]ue to the complexity of [the Subchapter C provisions] . . . , time has not permitted us to more than analyze these sections on their surface." H.R. Rep. No. 1337, 83d Cong. 2d Sess., B19.

[96] See discussion in Part II, *supra*.

[97] *See, e.g., Virginia Ice and Freezing Corp.* v. *Commissioner*, 30 T.C. 1251 (1958); *City Bank of Washington* v. *Commissioner*, 38 T.C. 713 (1962). Similarly, taxpayers may attempt to distribute appreciated assets in liquidation and avoid corporate level tax on the appreciation, while selling loss assets outside the 12 month section 337 period and recognizing losses.

be deferred in whole or in part through use of the installment method. The purchaser obtains a full step up in basis for the assets regardless of the amount of gain reported currently by the shareholders.

Accordingly, repeal of the *General Utilities* rule could be viewed as constituting a major step towards eliminating tax incentives to corporate acquisitions and mergers.

Relief measures

Some have suggested that if the *General Utilities* rule were repealed, it would be necessary, or at least appropriate, to provide relief from the double tax in certain cases. For example, relief might be provided on the basis of the type and holding period of the property and the size of the corporation involved. As noted above, the rule has been justified as a mechanism for avoiding a double tax on appreciation in assets held by a corporation that are largely investment or inflationary gains. Accordingly, it has been suggested that relief be provided only with respect to gains attributable to capital assets held by a corporation for a relatively long period of time. Such relief could be given to all corporations or, consistent with the argument that closely-held businesses are more likely to be adversely affected by repeal, might be limited to dispositions of such assets by small businesses.[98]

Relief could take one of several forms, including an exemption from tax at the corporate level,[99] an exemption from or deferral of tax at the shareholder level, or a shareholder credit for taxes incurred by the corporation on disposition of the property. Under the shareholder credit approach, the credit would be applied by the shareholder against the tax payable on the sale of his stock.[100] In its report, the staff of the Senate Finance Committee recommends adoption of a variation of the shareholder credit approach, but would confine this relief to acquisitions or liquidations involving certain small businesses. The shareholder would be allowed to increase the basis in stock in the corporation to reflect the corporate level tax on long-held capital assets. In addition, the staff proposal would permit shareholders of any corporation (not just small businesses) that liquidates in kind to defer the shareholder level tax with respect to property, other than cash, stock, securities, or similar property, distributed in liquidation. This would involve a substitute basis election similar to that contained in section 333 of present law.

Critics of these relief proposals argue that creating permanent relief provisions for certain businesses and assets would simply create new biases, distortions, and complexities in the tax system.

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[98] The final report of the Senate Finance Committee staff recommends the latter approach, confining relief to businesses with a fair market value of $1 million or less, for capital assets held for five years or longer. Decreasing partial relief would be provided for corporations up to $2 million in value.

[99] *See, e.g., General Utilities* Task Force Report, "Income Taxation of Corporations Making Distributions with Respect to Their Stock," 37 *Tax Law.* 625 (1984). This proposal by the ABA Tax Section Task Force would provide an exemption from the corporate tax for liquidating distributions of "historic" capital assets and section 1231 assets held for more than 3 years; for sales of such assets pursuant to a plan of liquidation; for sales and distributions of goodwill and other nonamortizable intangibles; and for distributions of controlled subsidiary stock.

[100] *See* American Law Institute, *Federal Income Tax Project: Subchapter C*, 134-131 (1982).

The arguments that the complete repeal of *General Utilities* would have some undesirable collateral effects on capital formation and the economy or would discourage use of the corporate entity are, they contend, largely unsubstantiated, as are arguments that small businesses would suffer most from repeal. Any potential inequities resulting from repeal could be addressed by providing liberal transition relief and phase-in rules. If Congress wishes to encourage small business or promote other social policies, these critics argue, there are better alternatives than using the tax Code. (Even within the tax Code, they contend, there are better, more direct alternatives such as further reductions in the graduated rate schedules.) If an unintegrated, two-tier system of taxation is deemed to be too harsh, Congress should provide relief in the form of full or partial integration on a nondiscriminatory basis.

Impact of repeal on other provisions of Code

Repeal of the *General Utilities* rule may create additional pressure for taxpayers to bring acquisition and liquidation transactions within the tax-free reorganization provisions of the Code. Furthermore, investors and entrepreneurs may resort to partnerships or other pass-through entities as vehicles for carrying on business. If this occurs, additional strain may be placed on the provisions of the Code relating to reorganizations, classification of entities, and taxation of pass-through entities. Congress may find it necessary to reexamine these provisions to assure that they are operating rationally and efficiently, and do not present opportunities for tax avoidance.

Alternatives to complete repeal

If Congress decides that a complete repeal of the *General Utilities* rule is unwarranted, it may wish to consider eliminating the nonrecognition treatment under section 336 for all liquidating dispositions of ordinary income assets, and repealing the remaining exceptions to recognition under section 311. In the hearings conducted by the Senate Finance Committee in 1983,[101] none of the witnesses advocated permanent relief for dispositions of assets outside a liquidation context. Furthermore, it has been contended that there is no logical basis for exempting inventory, whether or not sold in bulk, or other assets held for sale to customers in the ordinary course of business. Congress might also consider amendments to section 337 that would make "straddles" of that provision—that is, selective recognition of losses on depreciated assets without recognition of gain on appreciated assets—more difficult.

A more limited solution to the *General Utilities* problem would be to tighten the recapture provisions of the Code. For example, section 1250 could be modified to require that upon disposition of section 1250 property, an amount equal to the excess of depreciation claimed over the economic decline in value must be recognized as ordinary income to the transferor even if depreciation has been taken on a straight-line basis. This would conform the rules for depreciable real property with those for depreciable personal proper-

[101] "Reform of Corporate Taxation," Hearing before the Committee on Finance, United States Senate, 98th Cong., 1st Sess. (October 24, 1983).

Continued

ty (sec. 1245).[102] In addition, gain on all mineral property could be included in income to the extent of previously deducted intangible drilling costs, regardless of whether deducted before or after 1976, or whether the deductions exceed what could have been recovered through depletion deductions had they been capitalized. Similarly, gain on all mineral property could be required to be included in income to the extent of prior depletion deductions allowed or, alternatively, to the extent percentage depletion deductions allowed with respect to such property exceed those that would have been allowed under cost depletion.

[102] As previously noted, the Administration proposal states that consideration could be given to applying the limits imposed by the recapture rules on nonrecognition transactions, such as corporate liquidations, on a parallel basis with respect to real and personal property.

IV. ENTITY CLASSIFICATION

Present Law and Background

Classification as a partnership or corporation

Under present law, Treasury regulations provide that whether a particular entity is classified as an association taxable as a corporation or as a partnership, trust, or some other entity not taxable as a corporation is determined by taking into account the presence or absence of certain characteristics associated with corporations. These characteristics are (1) associates, (2) an objective to carry on business and divide the gains therefrom, (3) continuity of life, (4) centralization of management, (5) liability for entity debts limited to entity property, and (6) free transferability of interests.[103] These regulations are generally based on the principle stated in *Morrissey* v. *Comm'r*, 296 U.S. 344 (1935), in which the Supreme Court held that whether an entity is treated as a corporation depends not on its formal organization but on whether it more closely resembles a corporate than a noncorporate entity.

Of the characteristics mentioned above, the first two are common to both corporate and noncorporate business enterprises. Consequently, the remaining four factors are determinative. Treasury regulations state the corporate characteristics of an entity must make it more nearly resemble a corporation than a partnership or a trust for the entity to be treated as a corporation.[104] Although *Morrissey* suggested evaluation on a case-by-case basis, the Treasury regulations, while allowing for the presence of other "significant factors," simply count the presence or absence of the four stated factors; if fewer than three are present, an entity is not treated as a corporation. In this respect, the regulation goes further than *Morrissey* by providing that where there are an equal number of the critical "corporate" and "noncorporate" characteristics, the entity will not be classified as a corporation.

Attempts to expand the inquiry regarding partnership or corporation classification have not been successful. Regulations proposed in 1977[105] would have tightened the test with respect to the continuity of life and centralized management factors, and generally would have required the examination of additional factors if an entity had two of the four corporate characteristics. The proposed regulations were intended as a response to criticism that the existing regulations deviated from the "resemblance test" on which they were based, as articulated by the Supreme Court in *Morrissey*. These proposed regulations were withdrawn one day after they were issued.

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[103] Treas. Reg. sec. 301.7701-2(a).
[104] *Id.*
[105] 42 *Fed Reg.* 1038 (Jan. 5, 1977).

In addition, consideration of factors other than the four primary ones was limited in *Larson* v. *Comm'r*, 66 T.C. 159 (1976), *acq.* 1979-1 C.B. 1, in which the Tax Court held that a number of specified "other factors" were relevant only in evaluating the presence or absence of the four primary ones. The Internal Revenue Service later announced that it would follow *Larson*'s method of evaluating such other factors.[106] As a result, most limited partnerships formed under the Uniform Limited Partnership Act are not treated as corporations. These entities generally do not possess continuity of life and may often lack limited liability.[107]

Treatment of partnerships and grantor trusts

If as a result of the legal tests described above, an entity is classified as a partnership, it will generally be treated as a conduit for income tax purposes. The partnership itself will have no liability for tax and all items of income, expense, credit, etc., are allocated to and accounted for by the partners, including limited partners.

Similarly, if an entity is classified as a grantor trust, beneficiaries of the trust are treated as owners of a proportionate share of the trust's assets and account directly for the trust's items of income and expense. The grantor trust is often used, in a form known as a fixed investment trust, as a vehicle for the common ownership of investment assets. An example of such a trust is a so-called "mortgage pool," which involves the transfer of a group of mortgage loans to a trustee who holds the mortgages for the benefit of persons who have purchased or otherwise acquired interests in the trust.

Treatment of corporations

As discussed in Part II above, income earned by a corporation generally is subject to tax at the corporate level when earned and then subject to tax at the shareholder level when distributed. Nevertheless, several types of corporations are provided special exemption from this general scheme.

S corporations

In general, a corporation may elect to be treated under subchapter S of the Code (sec. 1361 *et seq.*) if it has 35 or fewer shareholders (none of whom are corporations or nonresident aliens), has not more than one class of stock, and is not a financial institution, a life insurance company, or one of several other types of corporations.

If such a corporation elects to be treated as subject to subchapter S, its shareholders generally account for a proportionate amount of the corporation's items of income, loss, deduction, and credit. The S

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[106] Rev. Rul. 79-106, 1979-1 C.B. 448.

[107] Continuity of life generally does not exist under the Uniform Limited Partnership Act even if partners agree in advance to continue the partnership upon the death or withdrawal of a general partner. Treas. Reg. sec. 301.7701-2(b). *See* Rev. Proc. 85-22, Sec. 3.41, I.R.B. 1985-12, 13. In addition, limited liability has been held to be absent even though the only partner with personal liablity is a corporation, unless the corporation *both* does not have substantial assets *and* is a mere "dummy" acting as the agent of the limited partners. *See Larson*, *supra*, 66 T.C. at 173-176, 179-182. The Internal Revenue Service has announced a study that will reconsider the acquiescence in *Larson* to the extent the acquiesence is inconsistent with the minimum capitalization requirement of Rev. Proc. 72-13, 1972-1 C.B. 735. Ann 83-4, I.R.B. 1983-2, 31.

corporation itself generally has no tax liability for so long as the election is in effect.

Regulated investment companies

In general, to qualify as a regulated investment company ("RIC"), a corporation must be a domestic corporation that either meets or is excepted from certain registration requirements under the Investment Company Act of 1940 (15 U.S.C. 80), that derives at least 90 percent of its income from specified sources commonly considered investment income, that has a portfolio of investments which is sufficiently diversified, and that also meets certain other requirements. Mutual funds, for example, generally qualify as RICs.

If a corporation meets these requirements and elects to be treated as a RIC, it generally would be subject to the regular corporate tax, but would receive a deduction for dividends paid provided that the amount of its dividends paid is not less than an amount generally equal to 90 percent of its ordinary income, including tax-exempt income. These dividends must be paid within a short period following the close of the RIC's taxable year and are generally includible as ordinary income to the shareholders.

A RIC that realizes capital gain income may be subject to tax at the corporate level at capital gains rates. If, however, the RIC pays dividends out of such capital gains, the dividends are deductible for the RIC in computing its capital gains tax and are taxable as capital gains to the recipient shareholders.

Real estate investment trusts

In general, an entity may qualify as a real estate investment trust ("REIT") if it is a widely held entity with freely transferable interests that would be taxable as an ordinary domestic corporation but for its meeting certain specified requirements. These requirements relate to the entity's assets being comprised substantially of real estate assets and the entity's income being in substantial part realized from certain real estate and real estate related sources.

If these requirements are met and the entity elects to be taxed as a REIT, like a RIC it generally would be subject to the regular corporate tax, and generally would be permitted a deduction for dividends paid to its shareholders within a short period after the close of its taxable year provided it distributes at least 95 percent of its taxable income, excluding capital gains. The treatment of capital gains for a REIT and its shareholders is similar to that for a RIC.

Cooperatives

Certain corporations are eligible to be treated as cooperatives and taxed under the special rules of subchapter T of the Code. In general, the subchapter T rules apply to any corporation operating on a cooperative basis (except mutual savings banks, insurance companies, most tax-exempt organizations, and certain utilities).

For Federal income tax purposes, a cooperative generally computes its income as if it were a taxable corporation, with one important exception—the cooperative may deduct from its taxable income patronage dividends paid. In general, patronage dividends

are profits of the cooperative that are rebated to its patrons pursuant to a preexisting obligation of the cooperative to do so. The rebate must be made in some equitable fashion on the basis of the quantity or value of business done with the cooperative. This rebate may be in a number of different forms.

In general, cooperatives are permitted to deduct patronage dividends only to the extent of net income derived from transactions with its members. Thus, cooperatives generally are subject to corporate tax on profits derived from transactions with nonmembers.[108]

Members of the cooperatives who receive patronage dividends must treat the dividends as income, reduction of basis, or some other treatment that is appropriately related to the type of transaction that gave rise to the dividend. For example, where the cooperative markets a product for one of its members, patronage dividends attributable to the marketing are treated like additional proceeds from the sale of the product and are includible in the recipient's income. Where the cooperative purchases equipment for its members, patronage dividends attributable to equipment purchases are treated as a reduction in the recipient's basis in the purchased equipment (provided the recipient still owns the equipment).

Analysis

Although the general scheme under present law treats corporations and their shareholders as separate entities and imposes tax on each, there are numerous exceptions, as discussed above.

The main issue raised by the existence of these exceptions is that in many cases taxpayers, by carefully selecting the type of entity through which they will carry on a business or investment activity, may elect whether or not to subject the income of the entity to the corporate tax, even though the taxpayer benefits from the entity's possession of corporate characteristics. Since the Administration proposal in the aggregate would increase the amount of taxes raised from corporations, it is not clear whether more taxpayers would then be encouraged to "elect out" of the corporate tax by taking advantage of some other type of entity.

In addition, the existence of these different possibilities may raise concerns about the fairness of the tax system. In particular, numerous tax shelter activities take advantage of the ability of limited partners to have the protection of personal limited liability and yet receive the use of entity losses.

Several recent proposals have addressed this situation. The 1984 Treasury Report contained a proposal to treat limited partnerships that have more than 35 partners as corporations. A 1983 Senate Finance Committee Staff Report on the taxation of corporations included a recommendation that publicly traded limited partnerships

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[108] In addition, if an entity qualifies as a tax-exempt farmers' cooperative under section 521(b) of the Code, it may generally deduct patronage dividends to the full extent of its net income and may also deduct, to a limited extent, dividends on its common stock. (See also note 11, Part II, *supra.*)

be taxed as corporations.[109] The 1984 ALI Subchapter K Project[110] also proposed the taxation of publicly traded limited partnerships as corporations. These and other proposals are discussed in a separate Joint Committee pamphlet. [111]

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[109] *See* Staff of the Senate Committee on Finance, 98th Cong., 1st Sess., *Report on the Reform and Simplification of the Income Taxation of Corporations* (S prt. 98-95), September 22, 1983, p. 80. The final report prepared by the Senate Finance Committee Staff (Senate Committee on Finance, *The Subchapter C Revision Act of 1985: A Final Report Prepared by the Staff* (May, 1985)) contains no such recommendation, apparently because of the fact that when that report was prepared, the 1984 Treasury report had published its broader proposal and the staff determined not to approach the issue in a piecemeal manner.

[110] ALI, *Federal Income Tax Project—Subchapter K* (1984), p. 392.

[111] *See* Joint Committee on Taxation, *Tax Reform Proposals: Tax Shelters and Minimum Tax* (JCS-34-85), August 7, 1985, pp. 38-41.

V. CERTAIN OTHER PROPOSALS

The statutory provisions that govern the tax treatment of corporations and their shareholders are found in Subchapter C (secs. 301-386). Subchapter C has been criticized on the grounds that certain provisions are overly complex and other provisions present unwarranted opportunities for tax avoidance. Certain proposals relating to the treatment of dividend distributions and the *General Utilities* doctrine have been discussed in Parts II and III above. This part of the pamphlet describes certain additional proposals.[112]

A. Corporate Distributions

In general, a corporation's earnings are taxed to its shareholders only upon distribution of those earnings. Dividend distributions are taxed to individual shareholders at a maximum rate of 50 percent. Individuals are taxed on long-term capital gains at a maximum rate of 20 percent.

A corporate shareholder is generally permitted to deduct 85 percent of the amount of dividends received from domestic corporations. Thus, because the maximum rate of tax on income received by a corporation is 46 percent, the maximum rate of tax on dividends received by a corporation is only 6.9 percent. A corporation's net capital gain (the excess of net long-term capital gain over net short-term capital loss) is subject to an alternative tax of 28 percent if the the tax computed using that rate is lower than the corporation's regular tax. Accordingly, a corporate shareholder may prefer a distribution to be characterized as a dividend, while an individual shareholder may prefer characterization as a "sale" of stock eligible for long-term capital gains treatment.

1. Character of Nonliquidating Distributions

Present Law and Background

In general, the amount of a distribution otherwise qualifying as a dividend by a corporation to a shareholder is includible in the shareholder's gross income as a dividend only to the extent the distribution is made out of the corporation's current or accumulated earnings and profits (secs. 301(c)(1) and 316(a)). If the distribution exceeds the corporation's earnings and profits, the excess is applied

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[112] For a proposal to revise subchapter C comprehensively, *see* Staff of Senate Comm. on Finance, 99th Cong., 1st Sess., *The Subchapter C Revision Act of 1985* (S. Prt. 99-47), May 1985. Additional corporate tax proposals relating to mergers and acquisitions are discussed in Joint Committee on Taxation pamphlets, *Federal Income Tax Aspects of Mergers and Acquisitions* (JCS-6-85), March 29, 1985, and *Federal Income Tax Aspects of Hostile Takeovers and Other Corporate Mergers and Acquisitions (and S. 420, S. 476 and S. 632)* (JCS-9-85), April 19, 1985. Proposals relating to corporate net operating loss carryovers are discussed in Joint Committee on Taxation pamphlet, *Limitations on the Use of Net Operating Loss Carryovers and Other Tax Attributes of Corporations* (JCS-16-85), May 21, 1985.

against and reduces the basis of the shareholder's stock (sec. 301(c)(2)). To the extent such a distribution exceeds the basis of the stock, the excess is treated as gain from the sale or exchange of property (sec. 301(c)(3)).

The purpose of the earnings-and-profits limitation generally is stated to be the protection of returns of capital from the tax on dividends.[113] Earnings and profits are thus generally intended to be a measure of a corporation's economic income that is available for distribution to shareholders.[114] Commentators have suggested that the purpose of identifying returns of capital is not well served, primarily because of the formulation of earnings and profits and the failure to take all the economic aspects of a shareholder's investment into account.

There is no comprehensive statutory definition of the term "earnings and profits," nor does the term have a counterpart in the accounting or other areas. Indeed, the term may not lend itself to ready definition. The applicable statute and Treasury regulations merely describe the effects of specified transactions on a corporation's earnings and profits (sec. 312). The effects of other transactions have been addressed by the courts and the Internal Revenue Service; however, for many transactions the law is unclear as to whether earnings and profits should be adjusted.[115] Further, it is necessary to take account of numerous transactions over the life of a corporation, including, for example, mergers or consolidations with other corporations and dispositions of assets.

In many instances, a corporation may have economic income but no earnings and profits for tax purposes. In such a case, the corporate laws of most states would permit dividends to be paid, although such dividends would be treated as returns of capital under the Internal Revenue Code. For example, for purposes of computing earnings and profits, depreciation is computed on a straight-line basis over specified periods, producing a result that may bear no relation to an asset's actual loss in value. Economic income is understated to the extent that depreciation is accelerated relative to an asset's actual loss in value. The rate of depreciation that accurately reflects economic income is itself subject to considerable debate.

The present-law rules are also subject to manipulation. For example, assume that a corporation has current earnings and profits, but a deficit in accumulated earnings and profits. If the corporation were to distribute the current earnings and profits, the distribution would be treated as a dividend, notwithstanding the deficit in accumulated earnings and profits. Alternatively, if the corporation did not expect to realize earnings during the next taxable

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[113] *See* B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* 7-4 (4th ed. 1979).

[114] *See* H.R. Rep. No. 861, 98th Cong., 2d Sess. 835 (1984) (Conference Report, *Deficit Reduction Act of 1984*).

[115] For a discussion of such issues, *see* B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* 7-16 to 7-23 (4th ed. 1979). In other cases, the law is clear but the appropriate measure of economic income may be subject to dispute. Depreciation is one example. As another, earnings and profits are reduced by the full amount of research and experimental expenditures expensed under section 174. Some have contended that this rule may not reflect economic income because such expenses may create assets with useful lives extending beyond a year. Others contend it is difficult to relate such expenses to particular assets and that expensing is an appropriate measure.

year, dividend treatment could be avoided by distributing the current earnings during the following year, as the only effect of the earnings after the end of the current year would be to reduce the deficit. Another example of the opportunities for tax avoidance is described in a 1983 report prepared by the staff of the Senate Finance Committee:

Example.—X corporation has no earnings and profits but has substantial unrealized appreciation on a building it owns. X obtains a mortgage on the building and distributes the proceeds to its shareholders. The distribution by X to its shareholders is tax free as a return of capital or is taxed as capital gain. Subsequent corporate earnings can then be used to pay off the mortgage without tax on the shareholders.[116]

The determination of whether there are earnings and profits is made at the corporate level, without regard to whether stock has changed hands or to the circumstances of particular shareholders. Thus, if a distribution is made out of accumulated earnings and profits with respect to stock that was acquired for a price that reflected those earnings, the distribution is taxed as a dividend, even if the corporation realized no additional earnings after the stock was acquired. In such a case, from an economic perspective, the shareholder can be viewed as receiving a return of capital.

Possible Proposal

In view of the defects of present law, and the complexity involved in computing earnings and profits, numerous commentators have suggested that the earnings-and-profits limitation should be eliminated.[117] Without an earnings-and-profits limitation, all distributions would be taxed as ordinary income, except distributions in redemption of stock. Proponents of eliminating earnings and profits justify this treatment on the grounds that it would treat an equity investment in a corporation like most other investments, e.g., interest payments are ordinary income even though the principal of the debt may never be repaid. Further, as described above, the present-law rules often fall short of measuring a shareholder's economic income, particularly where the corporation's stock has changed hands.

The repeal of the earnings-and-profits limitation would not necessitate changes in the basic structure of other provisions relating to corporate distributions. For example, the rules for distinguishing redemptions from ordinary distributions could apply without amendment (sec. 302). Similarly, the rule for the treatment of nonqualified consideration in tax-free reorganizations could also apply

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[116] Staff of Senate Committee on Finance, 98th Cong., 1st Sess., *Report on the Reform and Simplification of the Income Taxation of Corporations* (S. Prt. 98-95), September 22, 1983. For an example of this technique, *see Falkoff* v. *United States*, 604 F.2d 1045 (7th Cir. 1979).

[117] *See, e.g.*, Committee on Corporate Stockholder Relationships, American Bar Association, *Report on the Elimination of "Earnings and Profits" from the Internal Revenue Code* (the full text of which can be found in the August 12, 1985 Tax Notes Microfiche Data Base as Doc. 85-7217); Hearing before the Senate Committee on Finance, 98th Cong. (1983) (Statement of William D. Andrews); Staff of the Senate Committee on Finance, 98th Cong., 1st Sess., *Report on the Reform and Simplification of the Income Taxation of Corporations* (S. Prt. 98-75) September 22, 1983); Blum, *"The Earnings and Profits Limitation on Dividend Income: A Reappraisal,"* 53 *Taxes* 68 (1975).

with modifications (see also the proposal to eliminate the dividend-within-gain limitation, discussed in Part V.B.1., below).

Opponents of repealing the earnings-and-profits limitation question whether it would be appropriate to tax all distributions as ordinary income and whether existing complexity would be reduced, since a similar concept would still be required for purposes of other statutory provisions. For example, the concept is used in determining the allowability of indirect foreign tax credits associated with dividends received from affiliated foreign corporations (sec. 902). Nevertheless, some commentators have suggested that it might be possible to formulate a less complicated standard of measure for other purposes if the dividend-definition aspect were eliminated.[118]

As an alternative to repeal of the earnings and profits limitation, consideration could be given to amending the definition of earnings and profits to more clearly reflect economic income or income available for distribution—including, for example, a modification in the treatment of depreciation for earnings and profits purposes.

2. Bail-Outs Through Use of Related Corporations

Present Law and Background

Section 304 is designed to prevent shareholders from bailing out corporate earnings at capital gain rates through the device of selling stock in one corporation to a related corporation. In general, the sale of stock by a shareholder to a related corporation is treated as a redemption, with the result that the sale proceeds are taxed to the shareholder as a dividend unless the transaction qualifies under the rules for distinguishing a redemption from an ordinary distribution. The application of section 304 to corporate shareholders can produces incongruous results by characterizing amounts as dividends that are eligible for the dividends received deduction which generally benefits corporate taxpayers. Furthermore, Congress has found it necessary to address a host of technical problems that would not have arisen if the scope of section 304 were limited to individual shareholders. Finally, the application of section 304 has unintended effects that are unrelated to the purpose of the provision.

In the case of "brother-sister" transactions, if one or more persons in control of one corporation transfer stock in that corporation to another controlled corporation, the transaction is treated as a redemption of the shareholders' stock in the acquiring corporation (sec. 304(a)(1)). In the case of "parent-subsidiary" transactions, the transaction is recast as a redemption of the stock of the parent corporation (sec. 304(a)(2)). In determining the tax consequences of the deemed redemptions, dividend treatment generally results unless the transaction results in the termination of or a substantial reduction in the selling shareholder's interest (sec. 302). Even if the selling shareholder is treated as having sold the stock, the acquiring corporation is deemed to have received the stock as a contribution to capital (with the result that the corporation's basis in the stock

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[118] Hearing before the Senate Committee on Finance, 98th Cong. (1983) (Statement of William D. Andrews).

is determined by reference to the basis in the hands of the shareholder, not the corporation's purchase price).

The predecessor of section 304 (sec. 115(g) of the 1939 Code) was enacted in response to judicial decisions that permitted noncorporate taxpayers to avoid the ordinary income tax rates applicable to dividends by selling the stock of a controlled corporation to the corporation's subsidiary.[119] The House version of the original legislation limited the provision to cases in which "individuals" sold stock to related corporations. The Senate bill extended the provision to stock sales by corporations. The committee report that accompanied the Senate bill does not offer an explanation for this change.

The legislative history of the 1954 Code, which expanded the scope of the provision to include the sale of stock in one corporation to a commonly controlled corporation, indicates that the provision is intended to prevent tax avoidance.[120] In the case of individuals, section 304 discourages the prohibited transactions by treating what would be capital gain as dividend income. For corporations, however, dividends eligible for the dividends received deduction may be taxed significantly more lightly then capital gains. Thus, it is unclear what purpose is served by applying section 304 to corporate shareholders.

The application of section 304 to C corporations has engendered a number of technical corrections and other amendments that add to the complexity of the Code. For example, the Deficit Reduction Act of 1984 contained amendments that are designed to prevent the use of section 304 by corporations (1) to shift earnings and profits among members of controlled groups of corporations, and thereby create an opportunity to make nondividend distributions to noncorporate shareholders, and (2) to circumvent other statutory provisions that recharacterize gain on sale of stock in certain controlled foreign corporations as dividends that are ineligible for the dividends-received deduction.[121]

Possible Proposal

Consideration could be given to making section 304 inapplicable to the transfer of stock by corporate shareholders. In addition, where a selling shareholder is treated as having sold stock, the acquiring corporation could be treated as having purchased the stock. The latter proposal was included in the 1959 report submitted by the Advisory Group on Subchapter C to the House Committee on Ways and Means.[122]

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[119] *See* H.R. Rep. No. 2319, 81st Cong., 2d Sess. 53 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 43 (1950). *See also Commissioner* v. *Wanamaker*, 11 T.C. 365 (1948), *aff'd per curiam*, 178 F.2d 10 (3rd Cir. 1949) (which involved a stock sale by trustees of a testamentary trust and is cited in the 1950 committee reports).

[120] *See* H.R. Rep. No. 1337, 83d Cong., 2d Sess. 37 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 45 (1954). *See also Commissioner* v. *Pope*, 239 F.2d 881 (1st Cir. 1957) (which involved a stock sale by an individual, between commonly controlled corporations).

[121] *See* H.R. Rep. No. 861, 98th Cong., 2d Sess. 1222-1224 (1984) (Conference Report).

[122] *See* Hearings before the House Committee on Ways and Means, 86th Cong. (1959), *Revised Report on Corporate Distributions and Adjustments*, prepared by the Advisory Group on Subchapter C.

B. Tax-Free Corporate Organizations and Reorganizations

The corporate organization and reorganization provisions provide tax-free treatment to specifically described transactions that effect a readjustment of continuing interests in property in modified corporate form. For purposes of these nonrecognition provisions, qualified consideration is defined as stock or securities; anything else is "boot" that generally triggers taxable gain (but not deductible loss).

1. Dividend-Within-Gain Limitation on Boot Dividends

Present Law and Background

Generally, no gain or loss is recognized by shareholders or security holders who exchange stock or securities solely for stock or securities in a corporation that is a party to the reorganization (sec. 354(a)(1)). If the exchange also involves the receipt of nonqualifying consideration, gain is recognized up to the amount of the boot. Further, part or all of that gain may be taxed as a dividend if the exchange has the effect of a dividend (sec. 356(a)(2)). In determining whether an exchange has the effect of a dividend, the principles that apply for purposes of distinguishing redemptions from ordinary distributions are applied.[123] Thus, an inquiry is made as to whether the exchange effected a meaningful reduction in the shareholder's interest.[124]

Unlike the rules that apply to ordinary dividends, under the boot dividend rules, a shareholder's dividend income is limited to his ratable share of accumulated earnings and profits; current earnings and profits are not taken into account. If the amount of gain exceeds the allocable portion of earnings and profits, the excess is generally treated as capital gain.

Because the taxation of boot as a dividend is limited to an exchanging shareholder's gain, a shareholder may be able to withdraw corporate earnings at capital gain rates if the distribution occurs as part of a reorganization, even though the amount would be fully taxable as a dividend if distributed apart from a reorganization. This result is inconsistent with the theory that tax-free treatment is appropriate because the transaction is a continuation by the shareholder of his interest in the same corporate enterprise.

Possible Proposal

Consideration could be given to repealing the rule that treats boot as a dividend only to the extent of gain. The Advisory Group on Subchapter C included this proposal in its 1958 report to the House Committee on Ways and Means.[125] Further, the rule that

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[123] *See* Rev. Rul. 84-114, 1984-2 C.B. 90.

[124] There is conflicting authority regarding whether dividend equivalency should be tested by looking at a hypothetical redemption of the exchanging shareholder's interest in the acquired corporation or the acquiring corporation. *Compare Shimberg* v. *United States*, 577 F.2d 283 (5th Cir. 1978) *and* Rev. Rul. 75-83, 1975-1 C.B. 112 *with Wright* v. *United States*, 482 F.2d 600 (8th Cir. 1973). For a discussion of whether both approaches have application in particular circumstances, see Kyser, The Long and Winding Road: Characterization of Boot under Section 356(a)(2), 39 Tax L. Rev. 297 (1984).

[125] Hearing before the House Committee on Ways and Means, 86th Cong. (1959) *Revised Report on Corporate Distributions and Adjustments*, prepared by the Advisory Group on Subchapter C.

limits the amount of a boot dividend to the ratable share of accumulated earnings and profits could be repealed.[126] These proposals would have the effect of coordinating the rules for distributions occurring as part of a reorganization with those applicable to ordinary distributions.

2. Treatment of Securities as Boot

Present Law and Background

A shareholder or security holder is treated as receiving boot if the principal amount of securities received in a reorganization exceeds the principal amount of securities surrendered, or if securities are received and no securities are surrendered (sec. 354(a)(2)). In such a case, the amount of boot is the fair market value of the excess principal amount, or the fair market value of the principal amount if no securities are surrendered (sec. 356(d)).

Because the applicable statutory provision focuses on "principal amounts," but does not take the time value of money into account, the measurement of boot is distorted. For example, no amount is treated as boot as long as there is no differential between the principal amount of the security received and that of the security surrendered, even if the value of the new security exceeds the adjusted basis of the old security.

Possible Proposal

The amount of nonqualifying consideration received by an exchanging security holder could be measured by the difference between the adjusted issue price of securities surrendered and the issue price of securities received. The term "issue price" would be defined as in sections 1273 and 1274 (relating to the calculation of original issue discount). "Adjusted issue price" would be defined as in section 1275(a)(4)(B)(ii)(I).

Conforming amendments would be made to section 355, relating to the distribution of stock or securities of controlled corporations.

3. Treatment of Acquired Corporation's Debts

Present Law and Background

In general, no gain or loss is recognized by a corporation that exchanges property, pursuant to a plan of reorganization, solely for stock or securities of the acquiring corporation (sec. 361(a)). In addition, the transferor corporation recognizes no gain or loss on account of the receipt of boot, provided the corporation distributes the boot in pursuance of the plan of reorganization (sec. 361(b)). If a reorganization takes the form of one corporation transferring its assets to another corporation, the transferor corporation generally is required to completely liquidate. Because the transferor corporation goes out of existence, the parties to the reorganization must provide a mechanism for settling the corporation's debts. The tax consequences to the transferor corporation turn on the form, not

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[126] This modification would also be appropriate as a conforming amendment should the proposal to eliminate the earnings-and-profits concept be adopted.

the substance, of the transaction by which the corporation is relieved of its liabilities.

Under present law, the following procedures may be followed without the transferor corporation being treated as receiving boot, or otherwise recognizing gain:

(1) The acquiring corporation may assume the transferor corporation's liabilities, unless a principal purpose of the assumption or acquisition is tax avoidance (sec. 357). In such a case, the transferor corporation would receive qualified consideration with a value equal to that of the transferred assets, net of the liabilities assumed;

(2) the shareholders of the transferor corporation may assume its liabilities (in which case, the corporation would be viewed as having received a tax-free contribution to capital); or

(3) the transferor corporation may retain enough cash (or other liquid assets) to satisfy its liabilities.

In any case, the parties to the reorganization would end up in the same posture: the transferor corporation would be relieved of its liabilities, and the consideration ultimately received by its shareholders would be reduced by the amount of such liabilities. On the other hand, as described below, the use of other procedures that have the same economic effect may result in the recognition of income by the transferor corporation.

If the transferor corporation distributes boot to creditors rather than stockholders, the transfer would not be considered as made in pursuance of the plan of reorganization.[127] Thus, the transferor corporation would be taxed on receipt of the boot. In addition, the Internal Revenue Service views the transfer of qualified consideration to a creditor as a taxable exchange, resulting in the realization of gain or loss by the transferor corporation.[128] These tax consequences occur even though the parties to the reorganization may have been able to achieve the same economic results by utilizing one of the procedures described in the preceding paragraph.

One other possibility for nonrecognition treatment is provided by the statutory provision that governs the treatment of a corporation that liquidates within twelve months of adopting a plan of complete liquidation, described in Part III., above (sec. 337). If section 337 applies, the transferor corporation would recognize no gain or loss on a deemed sale to a creditor within the twelve-month liquidation period. This nonrecognition provision may be unavailable because there is conflicting case law regarding whether the liquidation provisions and the reorganization provisions are mutually exclusive.[129] In this connection, many tax practitioners assume that section 336, which is also a liquidation provision, provides nonrecognition treatment to a corporation that distributes qualified consideration pursuant to a plan of reorganization.[130] If so, it would

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[127] *Minnesota Tea Company* v. *Helvering*, 302 U.S. 609 (1938).

[128] Rev. Rul. 70-271, 1970-1 C.B. 166 (situation 1).

[129] *See, FEC Liquidating Corporation* v. *United States*, 548 F.2d 924 (Ct. Cl. 1977) (the application of which would deny nonrecognition treatment under section 337 on a "deemed sale" of stock to a creditor); and, *General Housewares Corporation* v. *United States*, 615 F.2d 1056 (5th Cir. 1980) (holding that section 337 applied where the acquired corporation sold part of the stock received as consideration for its assets in a reorganization and used the sale proceeds to pay debts).

[130] *See, e.g.*, B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders*, 14-103 n. 274 (4th ed. 1979).

appear that the application of section 337 should not be objected to on the grounds that the liquidation provisions cannot apply if the reorganization rules apply.

Possible Proposal

Section 361 could be amended to prevent the recognition of gain by an acquired corporation that uses qualified consideration or boot to pay off debts. In addition, present law could be clarified to expressly provide nonrecognition treatment to a corporation that disposes of consideration received pursuant to a plan of reorganization; in such a case, the application of sections 336 and 337 would be proscribed. If this proposal were adopted, the taxation of corporations that are acquired in reorganizations would no longer turn on the form in which the corporation's debts are settled.

4. Treatment of Acquiring Corporations in Triangular Reorganizations

Present Law and Background

Section 1032 provides nonrecognition treatment for a corporation that acquires property in exchange for its stock. In a triangular reorganization, a principal part of the consideration used by the acquiring corporation consists of stock of its parent corporation. Although the Internal Revenue Service has ruled that nonrecognition treatment is available to a corporation that uses its parent's stock as consideration in a transaction that qualifies as a reorganization,[131] the statutory support for such treatment is unclear.

Possible Proposal

Section 1032 could be amended to provide explicitly that no gain or loss is recognized on the transfer of parent-corporation stock pursuant to a plan of reorganization.

5. Boot Derived from Reorganizations Involving Certain Foreign Corporations

Present Law and Background

Under section 1248, gain recognized on the sale or exchange of stock in a foreign corporation by a U.S. person owning ten percent or more of the voting stock could be treated as a dividend. This rule was designed to prevent U.S. taxpayers from accumulating earnings free of U.S. tax in a controlled foreign corporation, and then (rather than repatriating the earnings in the form of dividends that would not be eligible for the dividends received deduction) disposing of the stock at capital gains rates for a price that reflects the accumulated earnings.

In general, section 1248(g) provides exceptions for cases in which realized gain is taxable as ordinary income under other provisions of the Code. In the case of gain realized in connection with a reor-

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[131] Rev. Rul. 57-278, 1957-1 C.B. 124 (without discussion of the basis for this conclusion). *See also* Prop. Treas. Reg. sec. 1.1032.2 (which would interpret section 1032 as reaching the desired result).

ganization, however, the statutory exception refers to "any gain realized on exchanges to which section 356 . . . applies" (sec. 1248(g)(2)). Thus, under a literal interpretation of the statute, section 1248 is inapplicable to a shareholder who receives boot pursuant to a plan of reorganization, even if the boot is taxed as capital gain.

Possible Proposal

The scope of section 1248(g)(2) could be limited to that of the other exceptions contained in section 1248(g). That is, the general rule should not apply to the extent that section 356 operates to characterize a shareholder's gain as dividend income, but would apply if the gain is taxed as capital gain.

6. Transfer of Property to Controlled Corporations

Present Law and Background

No gain or loss is recognized by a taxpayer who transfers property to an 80-percent controlled corporation solely in exchange for stock or securities in the corporation (sec. 351). Gain, but not loss, is recognized to the extent that the consideration for the transfer consists of property other than qualified consideration. The transferee's basis in the property is the same as the basis in the hands of the transferor, increased by the amount of gain (if any) recognized by the transferor (sec. 362). The transferor's basis in the stock or securities received is equal to the basis in the property transferred, increased by the amount of gain recognized and decreased by the amount of boot received (sec. 358).

Possible Proposals

In its report proposing the Subchapter C Revision Act of 1985,[131a] the staff of the Senate Finance Committee identified the following problem areas under section 351: (1) Although there is an overlap between section 351 and reorganization provisions, the limitations on the receipt of securities in a reorganization do not apply to a section 351 exchange; and (2) where the property transferred has a basis that exceeds its fair market value, taxpayers can duplicate corporate level losses.

Under the Senate Finance Committee staff proposal, the same nonrecognition rule that applies to securities received in a reorganization would apply to securities received in a section 351 exchange. Thus, securities would not be received tax-free if no securities were surrendered. Further, if the basis of the property transferred exceeded fair market value at the time of the exchange, then the transferor's basis in the qualified consideration received would equal the fair market value of the transferred property (increased by the amount of recognized gain and decreased by the amount of boot).

[131a] Staff of the Senate Comm. on Finance, 99th Cong., 1st Sess., *The Subchapter C Revision Act of 1985* (S. Prt. 99-47), May, 1985.

C. Miscellaneous Provisions

1. Depreciation Recapture in Certain Tax-Free Exchanges

Present Law and Background

The recapture rules prevent the conversion of ordinary income to capital gains by requiring gain on the disposition of depreciable property to be taxed as ordinary income (rather than capital gains), to the extent of depreciation deductions taken with respect to the property. Under present law, a taxpayer can effectively assign ordinary recapture income to another taxpayer by transferring depreciable property in a tax-free exchange. For example, section 1245(b) provides an exception to the recapture rule for depreciable personal property where the property is transferred to a controlled corporation in a transaction accorded nonrecognition treatment under section 351. Similarly, an acquired corporation recognizes no recapture income if it transfers depreciable assets in a tax-free reorganization. If depreciable property is transferred to a corporation that has net operating losses, for example, no tax may be imposed on the recapture income.

Possible Proposal

Consideration could be given to applying the depreciation recapture rules whenever an asset is no longer accounted for on the return that benefitted from the previously-claimed deductions. Thus, there would be recapture in all otherwise tax-free acquisitive reorganizations, as well as when a subsidiary is no longer included in the consolidated return of the affiliated group that claimed the deductions.[132]

Alternatively, some other mechanism could be devised to prevent the assignment of recapture income. For example, in a section 351 exchange, the shareholder's stock might be tainted so that ordinary income would result on disposition of the stock (or of the asset), to the extent of recapture income at the time of the section 351 transfer. In such a case, there would be a corresponding adjustment to the asset's basis in the hands of the corporation when the shareholder is taxed.

2. Conversion of a C Corporation to an S Corporation

Present Law and Background

In general, an S corporation is not subject to tax but is treated as a conduit, similar to the treatment of partnerships. Thus, shareholders who elect to treat their existing closely held corporation as an S corporation effect a material change in the tax character of their investment. Nevertheless, the conversion of a C corporation to an S corporation is not a taxable event.

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[132] Similarly, the Administration's proposal to impose a recapture tax on excess depreciation would prevent taxpayers from circumventing the proposed recapture rule by transferring property in nonrecognition transactions. This proposal is discussed in Joint Committee on Taxation, *Tax Reform Proposals: Taxation of Capital Income* (JCS-35-85), August 8, 1985.

Possible Proposal

An election to convert C corporations to S corporations, or certain acquisitions by S corporations of C corporations, could be treated as taxable events, at least with respect to recapture income.

3. Worthless Stock Deductions

Present Law and Background

Under section 165(g), taxpayers can deduct losses resulting from the worthlessness of corporate securities. Generally, such losses are capital losses. However, if a parent corporation owns at least 80 percent of each class of a subsidiary's stock and the subsidiary has derived more than 90 percent of its gross receipts from active business activities, the loss to the parent from worthlessness of the subsidiary's stock is an ordinary (rather than capital) loss. Whether stock is worthless is determined on the basis of facts and circumstances, some of which may be subject to the control of the parent.[133] The provision may be intended to prevent certain disparities in treatment between a branch and a subsidiary. However, it has been suggested that in some circumstances the availability of ordinary loss treatment may encourage a parent corporation to claim and cause worthlessness of a subsidiary rather than continue operations when the subsidiary stock has declined in value.

A separate issue may arise in the case of a non-consolidated subsidiary that is believed worthless in one year but is later revived by infusion of new assets. In *Textron, Inc.* v. *United States*, 561 F.2d 1023 (1st Cir. 1977) the court held that, even though the taxpayers had claimed an ordinary worthless stock deduction, the net operating losses of the subsidiary could still be used to shelter income from the new business.

Possible Proposals

Some argue that it would be desirable to eliminate the disparity between claiming worthlessness and otherwise disposing of subsidiary stock by requiring capital loss treatment in all cases.

With respect to the *Textron* issue, some have suggested a rule that whenever a corporation's stock becomes worthless, (or at least when this has produced an ordinary loss deduction), its preexisting tax attributes (such as net operating losses and credit carryovers) should be extinguished.

4. Taxes of a Shareholder Paid by the Corporation

Present Law and Background

If a corporation pays a tax imposed on a shareholder on an interest as a shareholder, present law allows a deduction to the corporation rather than the shareholder whose tax is paid (sec. 164(e)).

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[133] Facts that may be considered relevant and that may be subject to the parent corporation's control include the following: when the subsidiary is liquidated, when it terminates operations, when the parent ceases to advance operating capital, and when its operating officers abandon any hope or expectation of realizing a profit.

This rule is inconsistent with the general rule that taxes are deductible only by the person on whom they are imposed. The provision was originally adopted to provide a deduction to banks that voluntarily paid local taxes imposed on their shareholders, but operates to permit corporations to pay a deductible dividend. *See Hillsboro National Bank* v. *Commissioner*, 457 U.S. 1103 (1983). The extent to which the provision is in current use is unclear.

Possible Proposal

Section 164(e) could be repealed. If section 164(e) is repealed, a corporation's payment of a tax imposed on a shareholder would be treated as a taxable dividend to the shareholder.

5. Deferral by Solvent Taxpayers of Discharge of Indebtedness Income

Present Law and Background

In general

Code section 61(a)(12) provides that gross income includes "income from discharge of indebtedness." While in general the statute does not further define that term, discharge of indebtedness is generally considered to occur when a taxpayer's debt is forgiven, cancelled, or otherwise discharged by a payment of less than the principal amount of the debt. For example, if a corporation has issued a $1,000 bond at par which it later repurchases for only $900 (thereby increasing its net worth by $100), the corporation realizes $100 of income in the year of repurchase.[134]

Pursuant to certain statutory exceptions (sec. 108), income is not currently recognized from discharges arising in a title 11 (bankruptcy) case, or from discharges outside of bankruptcy to the extent the taxpayer is insolvent before the discharge.[135] Although income is not recognized currently in these bankruptcy or insolvency cases, certain tax attributes of the debtor—including net operating loss carryovers, certain credit carryovers, and the basis of assets—must be reduced, in a specified order, by the amount of the discharged debt, unless the taxpayer elects first to reduce the basis of depreciable property by the debt discharge amount. If the debt discharge amount exceeds the amount of tax attributes that can be reduced, it has no tax consequence.

In the case of a solvent debtor outside bankruptcy, the full amount of discharged debt generally is recognized as income in the year the discharge occurs. However, a solvent taxpayer may elect to adjust the basis in its depreciable assets (or realty held as inventory) in place of currently recognizing income (secs. 108(c) and 1017), thereby deferring recognition for tax purposes. This election is available for discharge of any indebtedness incurred by a corpo-

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[134] *United States* v. *Kirby Lumber Co.*, 284 U.S. 1 (1931); *Helvering* v. *American Chicle Co.*, 291 U.S. 426 (1934); *Comm'r* v. *Jacobson*, 336 U.S. 28 (1949); Treas. Reg. sec. 1.61-12(a).

[135] If a taxpayer is insolvent before the discharge occurs, the amount of the taxpayer's insolvency must be determined. If the amount of the discharge exceeds the amount of the taxpayer's insolvency, the excess must be currently recognized as income unless excepted under some other provision.

ration, or indebtedness of an individual incurred in connection with the individual's trade or business (sec. 108(d)(4)).

For an electing solvent taxpayer, the adjustment is made by reducing the basis, but not below zero, of depreciable assets held at the beginning of the taxable year following the year in which the discharge of indebtedness occurs (sec. 1017(a)). If the debt discharge amount exceeds the amount of basis in depreciable property, the excess is not eligible for the election and must be currently recognized as income.

Reduction of basis under this election is subject to recapture as ordinary income on sale of the property whose basis was reduced (sec. 1017(d)). However, reduction of basis does not constitute a disposition of property for any tax purpose, including recapture of the investment tax credit (sec. 1017(c)(2)).

A provision allowing solvent debtors to reduce the basis of assets rather than recognize immediate income on a discharge of business debt has been in effect since 1939. The original provision was limited to solvent corporate taxpayers in "unsound financial condition." The financial condition limitation was later dropped due to administrative difficulties in identifying such taxpayers.[136] The 1954 Code extended the election to individuals (if the debt had been incurred in connection with property used in the taxpayer's trade or business). The Bankruptcy Tax Act of 1980 modified the rule further so that a solvent debtor, to avoid current taxation, must reduce basis in depreciable assets.

In the case of a solvent debtor outside bankruptcy, present law also provides that if a seller of specific property reduces the debt of the purchaser that arose out of the purchase, the reduction to the purchaser of the purchase money debt is treated (for both the seller and the buyer) as a purchase-price adjustment on that property. This provision was enacted to eliminate disputes between the Internal Revenue Service and the debtor as to whether in a particular case the debt reduction should be treated as discharge of indebtedness income or a true price adjustment.[137] If the debt has been transferred by the seller to a third party (whether or not related to the seller), or if the property has been transferred by the buyer to a third party (whether or not related to the buyer), this provision does not apply to determine whether a reduction in the amount of purchase-money debt should be treated as discharge income or a true price adjustment. Also, this provision does not apply where the debt is reduced because of factors not involving direct agreements between the buyer and the seller, such as the running of the statute of limitations on enforcement of the obligation.

Internal Revenue Service study of basis adjustment by solvent corporations

In 1980, the Treasury Department reported on an Internal Revenue Service study on the ability of solvent corporations (outside bankruptcy) to avoid recognizing current income from discharge of

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[136] S. Rep. No. 1631, 77th Cong., 2d Sess. 46 (1942).

[137] See H. Rpt. No. 96-83, 96th Cong., 2nd Sess. (1980); S. Rpt. No. 96-1035, 96th Cong., 2nd Sess. (1980).

indebtedness by reducing asset basis.[138] (Under the law in effect at the time of the study, the debtor could reduce basis in nondepreciable assets that might never be sold, thereby completely avoiding—rather than deferring—the tax consequences of debt discharge.) The study examined approximately 215,000 corporate returns filed during a six-month period during 1979, 65 of which had made use of the election.

According to the study, the basis-reduction election was "apparently used disproportionately by the very largest corporations." Thus, more than half of the electing corporations had assets in excess of $250 million, although such corporations made up only one-tenth of one percent of all corporations at that time. Also, only three of the 65 had assets of less than $1 million, despite the fact that such corporations constituted 91 percent of all corporations at that time. In addition, the study found that only 25 percent of the electing corporations had reported a tax loss in any of the four most recent taxable years and that only 11 percent had reported a tax loss in more than one of the four most recent taxable years.

Possible Proposals

It has been suggested that present law may provide an inappropriate tax deferral to those solvent taxpayers (outside bankruptcy) who elect to reduce the basis of depreciable assets and thereby avoid currently recognizing income from a discharge of qualified business indebtedness. It is pointed out that even if some deferral were viewed as appropriate, the particular deferral resulting from reduction of basis in depreciable property may not produce an effect consistent with any particular policy goal.

Under one possible proposal, the present-law rules could be modified either to require the current inclusion in income of the full debt discharge amount, or to provide a method of deferral that matches the discharge of indebtedness income against any additional costs incurred to obtain the discharge. If it is deemed desirable to permit additional deferral in the case of a taxpayer that is financially troubled (but not insolvent or bankrupt) at the time of business debt discharge, consideration could be given to treating such "workout" situations separately from refinancings occasioned by more general changes in interest rates, and to adopting a more evenhanded method of determining the deferral period, such as permitting deferral over a specified time period.

Analysis

Overview

The election granted a solvent taxpayer to reduce the basis of depreciable assets rather than recognize current income in the discharge of business indebtedness evolved out of a provision originally intended to assist financially troubled taxpayers for whom immediate income recognition could be a hardship.

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[138] *Written Comments on Certain Aspects of H.R. 5043; Bankruptcy Tax Act of 1979*, Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means, 96th Cong., 2nd Sess. (February 20, 1980) (statement of Daniel I. Halperin, Deputy Assistant Secretary of the Treasury).

The Internal Revenue Service study (referred to above) indicated that most corporate use of basis-adjustment deferral (as reflected on returns filed over a six-month period in 1979) was by large, profitable corporations. This suggests that repurchase of debt whose value had declined due to a general rise of interest rates may have played a significant role in obtaining discharges of indebtedness by these corporations.

Proponents of a change in present law contend that the substantial carryover period now allowed for net operating losses (generally, 15 years) may provide adequate relief to taxpayers that obtain discharges of business debt in the context of financial difficulties and that allowing solvent taxpayers to reduce the basis of depreciable assets instead of recognizing current income permits inappropriate deferral. Thus, they question whether any deferral is desirable.

Some may argue that even given the present law net operating loss carryover rules, it might still be desirable to provide relief to financially troubled taxpayers. Since identifying these taxpayers has proven administratively difficult in the past, they may urge retention of present law, even though it permits deferral that varies based on the taxpayer's depreciable assets. Another approach would be to permit deferral in hardship cases over a specified time period (*cf.* sec. 6161(b)).

Another approach would be to permit an offset to income, or a deferral, only to the extent additional expenses of refinancing are incurred and can be demonstrated.

Additional expense example; repurchase of debt

Where discharge income arises as a result of the repurchase of the taxpayer's own debt, additional expenses may be incurred in order to obtain the discharge based on the source of the funds used to repurchase the debt. If only internally generated funds are used, no additional charges may be incurred other than the transaction costs associated with the repurchase. In this case, there is no future stream of expenses against which to offset the income from discharge. Accordingly, unless deferral is desired for some other reason such as relief to a financially troubled taxpayer, the appropriate time for recognition of discharge income should be the taxable year in which the repurchase occurs.

If the money needed to repurchase the debt is borrowed, it is likely that additional expenses will be incurred in the form of additional interest payments. Generally, the debt will not be available for repurchase at a discount from its principal amount unless the interest at which that debt was originally issued is now less than the rate the market will demand for current borrowing from the taxpayer. Whether this change represents a general movement in interest rates, or a change in the credit worthiness of the taxpayer, the result should be the same. In order to borrow the funds to repurchase the debt, a higher interest rate must be paid.

The following example shows two roughly equivalent notes with their discounted present values at 12.68 percent interest per year. The first note was issued for $100,000 when interest rates were 10 percent and can now be repurchased for $90,492. In order to effect

the repurchase, a new note for $90,492 paying market interest will have to be issued.

Year	Old Note		New note	
	Nominal value	Present value	Nominal value	Present value
1	$10,000 (i)	$8,875	$11,475 (i)	$10,185
2	10,000 (i)	7,876	11,475 (i)	9,039
3	10,000 (i)	6,989	11,475 (i)	8,020
4	10,000 (i)	6,202	11,475 (i)	7,119
5	10,000 (i)	5,505	11,475 (i)	6,318
5	100,000 (P)	55,045	90,492 (P)	49,811
Total		90,492		90,492

The numbers used in the example reflect rounding for presentation purposes. I=interest; P=principal.

In this case, there is discharge of indebtedness of $9,508, the difference between the principal amount of the original note and the price at which it is repurchased. However, the taxpayer must pay a cost to obtain the discharge in the form of an additional $1,475 per year of interest for five years, or a total of $7,375.

In order properly to match income with the expenses incurred to produce such income, at least $7,375 of the $9,508 discharge income should be offset against the additional interest expense. The remaining $2,133 could also be matched against the additional interest or could be required to be recognized immediately.

In some situations, it may be difficult to tell exactly which new debt is replacing what repurchased debt, or to determine against which stream of interest payments the discharge income should be matched. Since the deferral provides a benefit to taxpayers as compared with immediate recognition, the taxpayer could be required to show clearly which new debt is the replacement debt. This could be done by requiring replacement debt to be designated as such at the time of its creation, and by requiring a tracing of the proceeds of the replacement debt to the transactions resulting in the discharge of indebtedness. Some might contend that any permitted tracing should be limited to fairly obvious refinancing cases, in light of the general administrative difficulty of tracing borrowed funds.

The repurchase of debt example is only one area in which additional expenses may be incurred in order to obtain discharge of indebtedness income. If such expenses are incurred in other types of discharges of qualified business indebtedness, and matching is desired, a similar approach could be used.

6. Basis in Stock of Controlled Subsidiary

Present Law and Background

Although the acquisition of a corporation's stock and the acquisition of its assets often have identical economic consequences, the

tax consequences of the two transactions may vary. One discontinuity that results relates to the difference between an acquiring corporation's basis for stock in the acquired corporation ("outside basis") and the acquired corporation's asset basis ("inside basis"). For example, if an acquiring corporation acquires stock, the acquired corporation's basis for its assets would be unaffected (unless a section 338 election is made to treat the stock acquisition as an asset acquisition). In such a case, the acquiring corporation's outside basis may have no relation to the inside basis. In contrast, if the acquiring corporation purchases assets and contributes the assets to a newly formed subsidiary corporation (or is treated as having purchased assets under section 338), the inside and outside bases would be comparable. Further, unless the acquired corporation is included in the acquiring corporation's consolidated Federal income tax return, the acquired corporation's earnings would not increase the outside basis (although the inside basis would be increased by subsequent earnings).

Possible Proposal

In its proposed Subchapter C Revision Act of 1985,[139] the staff of the Senate Finance Committee suggests a rule that would conform the outside basis of a controlling corporate shareholder to the inside basis. This rule is thought to be necessary because present law permits taxpayers to claim double gains or double losses where there is a disparity between inside and outside basis (similar to the problem discussed in Part V.B.6., above, relating to section 351 exchanges). Further, there is a concern about discontinuities between the treatment of stock acquisitions and asset acquisitions.

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[139] See n. 131a, *supra*.

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